Buffalo Law Review

Volume 51 | Number 3 Article 4

7-1-2003

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INTRODUCTION

In January 2001, Larry Ellison, the Chief Executive Officer ("CEO") of Oracle Corporation, exercised 23 million stock options for a total gain of more than $706 million.[1] Only weeks later, Oracle lowered its earnings forecasts, initiating a dive in its stock price.[2] While the stock traded for over $30 per share before the announcement—and had seen prices over $40 per share within the past year—it dropped to below $20 per share by the end of 2001, and was around $11 per share at the end of 2002,[3] dropping almost twice as fast as the S&P 500 Index.[4]

From 1996 to 2002, Michael Eisner, the CEO of the Walt Disney Company, received an average of $123 million per year in total compensation.[5] During that same period, Disney shareholders received an average annual return of 2%,[6] while the S&P 500 Index nearly doubled.[7] The stock, which has seen highs above $40 per share, traded at the end of 2002 at around $17 per share.[8]

Examples of compensation packages apparently divorced from measures of corporate performance did not end with the popping of the internet stock bubble. In January of 2002, Jeffrey C. Barbakow, the CEO of Tenet Healthcare, sold $111 million of the company's stock.[9]

1. John A. Byrne et al., *How to Fix Corporate Governance*, BUS. WK., May 6, 2002, at 69, 70.

2. *Id.*

3. *See* CNN Money, *Five Year Price Chart For Oracle Corporation, at* http://qs.cnnfn.cnn.com/tq/stockquote?symbols=ORCL&gt=5yr (last vistied Sept. 2, 2003).

4. *See* Yahoo! Finance, *S&P 500 Five Year Price Levels, at* http://finance.yahoo.com/q?s=^GSPC&d=c&t=5y&l=on&z=b&q=l (last visited Sept. 2, 2003).

5. *See* Bernard Condon, *Collect Now, Deliver Later*, FORBES May 13, 2002, at 112, 112.

6. *Id.*

7. *See* Yahoo! Finance, *S&P 500 Index Price Levels Since 1983, at* http://finance.yahoo.com/q?s=^GSPC&d=c&k=c1&a=v&p=s&t=my&l=on&z=m&q=l (last visited Sept. 2, 2003).

8. *See* CNN Money, *Five Year Index for Walt Disney Company, at* http://qs.cnnfn.cnn.com/tq/stockquote?symbols=DIS&gt=5yr (last visited Sept. 2, 2003).

9. *See* David Leonhardt, *Options Payday: Raking It In, Even as Stocks Sag*, N.Y. TIMES, Dec. 29, 2002, § 3, at 1.

Shortly before the sale, Barbakow had described the corporation's business as "sensational" and increased its projected earnings.[10] Despite this optimistic forecast, the company's earnings proved disappointing, and its stock plunged some 60% over the following year,[11] nearly three times faster than the market as a whole.[12]

Examples like these led one commentator to describe excessive CEO pay as the "mad-cow disease of American boardrooms."[13] While these stories are at the extreme end of the scale, they do provide some sense of the magnitude of the problems with CEO compensation. In 2001, CEOs of large corporations made 411 times as much as the average factory worker.[14] In the past ten years, as employee salaries rose an emaciated 36%, CEO compensation growth approached 340%, to $11 million.[15]

Executive compensation is only one example of the central problem in corporate governance: the separation of ownership and control in public corporations.[16] While dispersed, disaggregated shareholders own public corporations, corporate executives control them.[17] This divergence of ownership and control opens the door wide to opportunistic behavior by managers, allowing them to operate the corporation to serve their own ends rather than those of the corporation's owners—the shareholders.[18] This problem runs through most of corporate governance law, from hostile takeovers[19] to shareholder resolutions[20] to

10. *Id.*

11. *Id.*

12. *See* Yahoo! Finance, *supra* note 4.

13. *See* Byrne et al., *supra* note 1, at 71.

14. *Id.* at 72.

15. *Id.*

16. For a detailed discussion of why the current state of executive compensation is a serious problem, see *infra* Part II.

17. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 112-16 (Transaction Publishers 1991) (1932).

18. *Id.* at 116 ("[W]here the bulk of the profits of enterprise are scheduled to go to owners who are individuals other than those in control, the interests of the latter are as likely as not to be at variance with those of ownership and . . . the controlling group is in a position to service its own interests.").

19. During a hostile takeover, managers face a strong likelihood of losing their jobs. Managers may therefore resist hostile takeover attempts even if the offered price for shareholders' shares includes a large premium over the preexisting market price. In other words, the split between ownership and control may lead managers to combat offers that shareholders would prefer the corporation accept. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946,

securing the corporation's obedience to the law.[21] Other factors such as culture, individual psychology, and particular governance mechanisms also play a role, but the ownership/control split remains the dominant source of systematic corporate governance problems.

Proposed solutions to this dilemma broadly fall into two groups: the free market school and the regulatory school.[22] Free market approaches argue that eventually an unfettered marketplace will solve all apparent governance problems.[23] Participants' enlightened self-interest will cause the market to demand appropriate solutions, and those corporations that do not heed this call will fall to Darwinian selection.[24]

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955 (Del. 1985) ("We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.") (quoting Bennett v. Propp, 182 A.2d 405, 409 (Del. 1962)).

20. "Under state statutes, shareholders have power only with respect to a very limited range of matters: amendments of articles of incorporation, mergers, sales of all or substantially all of the corporation's assets, dissolution, and election and removal of directors." ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 157 (1999). The shareholders, who own the corporation, are therefore sharply limited in their legal entitlement to control it. *Id.* at 157-58.

21. Directors and officers sometimes cause the corporation to violate the law in breach of their fiduciary duties to shareholders. *See, e.g.*, Miller v. Am. Tel. & Tel. Co., 507 F.2d 759, 762 (3d Cir. 1974) (explaining that illegal actions by directors constitute a breach of fiduciary duty owed to shareholders even if the directors intended to benefit the corporation).

22. *See* PINTO & BRANSON, *supra* note 20, at 113-14 (describing the major theoretical approaches as the regulatory approach, the management approach, which favors giving managers wide latitude on the theory that they will be motivated to act efficiently because their livelihood depends on the corporation's success, and the law and economics approach). Although Pinto and Branson divide the free market approach into the management approach and the law and economics approach, these are not really different approaches. Both involve the use of rational, financial incentives to motivate managers to act in shareholders' interests.

23. *Id.* at 114-16 (describing the law and economics approach). The article uses the term "free market approach" because law and economics can be used to justify regulation when there are market failures. *See generally* Jon D. Hanson & Kyle D. Logue, *The Costs of Cigarettes: The Economic Case for Ex Post Incentive-Based Regulation*, 107 YALE L. J. 1163 (1998) (arguing that because consumers do not internalize the harm that smoking causes them and others—a market failure—regulation is necessary).

24. *See* PINTO & BRANSON, *supra* note 20, at 115 (explaining that since poor management may result in the company's failure, the market for managers will ensure that managers will work efficiently).

Regulatory approaches, on the other hand, contend that governance problems stem from market failures that must be corrected by regulation.[25] Selfish rational actors may lack sufficient information, predictive ability, or incentive to reach the socially optimal result through unmanaged competition.[26] Moreover, human rationality is bounded, subject to numerous heuristics and biases that warp perceptions of which choices are strategically correct.[27] As a result, regulation is sometimes necessary to force the disclosure of information, to structure appropriate incentives, or to protect market participants from their own lapses in rationality.

This article proposes a third mode of analysis for corporate governance problems: altruistic theory. The free market school relies on two assumptions about human behavior: rationality and selfishness.[28] The regulatory school applies research that indicates ways in which the rationality assumption is fundamentally flawed, attempting to correct the problems created by these flaws through regulation.[29] Behavioral economists and psychologists have performed studies that indicate the selfishness assumption of the free market approach is similarly dubious.[30] This article takes the first step toward correcting that error by exploring how and why people behave unselfishly, with the hope that these studies can be harnessed to promote unselfish behavior in corporate directors and executives. The article explores these issues using the case study of executive compensation, aiming to instill altruism in

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25. *Id.* at 113.

26. *See generally id.* (stating that the regulatory approach is based on arguments of unaccountability of managers and market failures).

27. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics, in* BEHAVIORAL LAW AND ECONOMICS 14, 14-15 (Cass R. Sunstein ed., 2000) (explaining the notion of bounded rationality).

28. Nobel Prize winning economist Gary Becker has stated, "[A]ll human behavior can be viewed as involving participants who (1) maximize their utility (2) from a stable set of preferences and (3) accumulate an optimal amount of information and other inputs in a variety of markets." *Id.* at 14 (quoting from GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 14 (1976)). In an attempt at simplification, this article characterizes narrow utility maximization (as distinguished from utility functions that incorporate a taste for altruism) as selfishness, and combines stable preferences and optimal inputs into a single rationality assumption.

29. *See* PINTO & BRANSON, *supra* note 20, at 113 (explaining that the regulatory approach points to market failures as a justification for regulation).

30. *See infra* Part III.

directors so that they will bargain more forcefully with executives over their pay.

The notion that altruistic theory has a role to play in this context seems shocking, especially in light of the reports in the popular press about recent corporate excesses.[31] Discussing altruism in this context sounds naive. Yet outside of this arena, most of us would willingly acknowledge that people behave unselfishly with some frequency. In fact, we would take as insulting the contrary position when applied to ourselves. Of course we are not entirely egoistic, of course we care about the well-being of others, and of course we often sacrifice our own interests in order to help those in need. This calm acceptance of altruism's existence evaporates when discussing the corporate world, as though directors were something other than human or checked their personalities at the boardroom door.

To some extent, this skepticism may actually be sensible. Competitive corporate cultures may well emphasize the value of hard-edged reason, disparaging compassion and encouraging narrow, self-interest analysis. Nevertheless, numerous studies by behavioral economists and psychologists have documented environmental and personality factors that foster altruistic behavior.[32] Subjects

31. *See, e.g.*, Andrew Ross Sorkin & Jonathan D. Glater, *Some Tyco Board Members Knew of Pay Packages, Records Show*, N.Y. TIMES, Sept. 23, 2002, at A1 (describing evidence that the board knew of executives' "extravagant pay packages" despite claiming not to); Kurt Eichenwald, *The Findings Against Enron*, N.Y. TIMES, Sept. 23, 2002, at C1 (explaining that bankruptcy examiner made preliminary findings that Enron violated public disclosure rules and pointed out areas of possible fraud with a potential scope of some $1.4 billion); Byrne et al., *supra* note 1, at 69 (cover story on the "crisis in corporate governance"); Leonhardt, *supra* note 9, at 1 (describing high executive pay despite sagging performance).

32. *See, e.g.*, C. DANIEL BATSON, THE ALTRUISM QUESTION: TOWARD A SOCIAL-PSYCHOLOGICAL ANSWER 109-201 (1991); NANCY EISENBERG, ALTRUISTIC EMOTION, COGNITION, AND BEHAVIOR 188-212 (1986); ALFIE KOHN, THE BRIGHTER SIDE OF HUMAN NATURE: ALTRUISM AND EMPATHY IN EVERYDAY LIFE 65-85 (1990); J. PHILIPPE RUSHTON, ALTRUISM, SOCIALIZATION, AND SOCIETY 38-57 (1980); C. Daniel Batson & Jay S. Coke, *Empathy: A Source of Altruistic Motivation for Helping?*, *in* ALTRUISM AND HELPING BEHAVIOR: SOCIAL, PERSONALITY AND DEVELOPMENTAL PERSPECTIVES 167, 171-72, 180-185 (J. Philippe Rushton & Richard M. Sorrentino eds., 1981); Leonard Berkowitz, *Social Norms, Feelings, and Other Factors Affecting Helping and Altruism*, *in* 6 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 63 (Leonard Berkowitz ed., 1972); Gustavo Carlo et al., *The Altruistic Personality: In What Contexts Is It Apparent?*, 61 J.

are more willing to assist a person in need when, *inter alia*, their perception of that need is clear,[33] they believe they have the capacity to help,[34] they empathize with the person in need,[35] helping norms are salient,[36] they feel some responsibility towards the person in need,[37] and they

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PERSONALITY & SOC. PSYCH. 450 (1991); John F. Dovidio, *Helping Behavior and Altruism: An Empirical and Conceptual Overview, in* 17 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 361 (Leonard Berkowitz ed., 1984); Harvey A. Hornstein, *The Influence of Social Models on Helping, in* ALTRUISM AND HELPING BEHAVIOR: SOCIAL PSYCHOLOGICAL STUDIES OF SOME ANTECEDENTS AND CONSEQUENCES (J. Macaulay & L. Berkowitz eds., 1970); Rabindra N. Kanungo & Jay A. Conger, *The Quest for Altruism in Organizations, in* APPRECIATIVE MANAGEMENT AND LEADERSHIP: THE POWER OF POSITIVE THOUGHT AND ACTION IN ORGANIZATIONS 228-38 (Suresh Srivastva & David L. Cooperrider eds., 1990); M. Audrey Korsgaard et al., *Beyond Helping: Do Other-Oriented Values Have Broader Implications in Organizations?*, 82 J. APPL. PSYCHOL. 160 (1997); Shalom H. Schwartz, *Normative Influences on Altruism, in* 10 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 221, 242-73, (Leonard Berkowitz ed., 1977); Shalom H. Schwartz & Judith A. Howard, *Internalized Values as Motivators of Altruism, in* DEVELOPMENT AND MAINTENANCE OF PROSOCIAL BEHAVIOR: INTERNATIONAL PERSPECTIVES ON POSITIVE MORALITY 229 (Ervin Staub et al. eds., 1984); Ervin Staub, *A Conception of the Determinants and Development of Altruism and Aggression: Motives, the Self, and the Environment, in* ALTRUISM AND AGGRESSION: BIOLOGICAL AND SOCIAL ORIGINS 135 (Carolyn Zahn-Waxler et al. eds., 1986).

33. *See* BATSON, *supra* note 32, at 75, 83, 225-26; EISENBERG, *supra* note 32, at 189-95; Berkowitz, *supra* note 32, at 73; Kanungo & Conger, *supra* note 32, at 253; Schwartz, *supra* note 32, at 242-45; Schwartz & Howard, *supra* note 32, at 232-33; and Staub, *supra* note 32, at 136.

34. *See* KOHN, *supra* note 32, at 75; Berkowitz, *supra* note 32, at 73; Schwartz, *supra* note 32, at 245-46; Schwartz & Howard, *supra* note 32, at 233.

35. *See* BATSON, *supra* note 32, at 47-57 (summarizing theories of, *inter alia*, Martin Hoffman, Dennis Krebs, Melvin Lerner, and Piliavin, Dovidio, Gaertner, and Clark); Dovidio, *supra* note 32, at 370-72 (summarizing theories of Batson and Coke); Staub, *supra* note 32, at 141-43.

36. *See* Berkowitz, *supra* note 32, at 78 ("An increasing number of social psychological investigations have demonstrated that the sight of a person (the model) carrying out a paticular action can indeed heighten the onlookers' own inclination to behave this way themselves."); Hornstein, *supra* note 32, at 30-31 (explaining that the observation of helpful social models may induce helping behavior because the model demonstrates how people like the observer are expected to behave); Staub, *supra* note 32, at 155 ("There is substantial evidence that prior participation in prosocial behavior increases adults' subsequent positive actions . . . .").

37. *See* BATSON, *supra* note 32, at 186, 191, 199; RUSHTON, *supra* note 32, at 42-46 (explaining norms of social responsibility that help lead to helping behavior); Berkowitz, *supra* note 32, at 72-73 (citing various theorists who argue that feelings of responsibility help lead to altruistic behavior); Hornstein, *supra* note 32, at 29 ("In any given situation it is incumbent upon the person involved to determine whether the particular situation is one in which he,

possess high self-esteem and/or an elevated mood.[38] These results open the door to designing governance institutions that encourage altruistic behavior, even in the face of contrary corporate norms of self-interest. Nevertheless, there do not appear to have been any attempts to apply such research in designing social institutions for corporate governance until now.

There may be sharp limits to altruism's ability to blunt directors' self-interest, particularly in an arena such as compensation, where executives' opposition can be expected to be most forceful.[39] Certainly it would be too much to expect altruism-fostering institutions to energize boards enough for the newly altruistic boards to eliminate excessive and poorly structured compensation (much less all problems stemming from the separation of ownership and control). But no reform device could pass such a stringent test in this area. The underlying problem of the separation between ownership and control is too fundamental to be susceptible to absolute solutions. Our expectations for reform mechanisms must be more modest and practical—to create institutions that ameliorate the

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especially, should assume responsibility for another person's welfare."); Kanungo & Conger, *supra* note 32, at 253 ("The social psychological literature on helping behavior and social loafing. . . clearly suggests that people engage in altruistic acts when they perceive the need for such acts and accept responsibility for them."); Schwartz, *supra* note 32, at 230 (explaining studies which show personal norms are unrelated to altruistic behavior among those who tend to deny responsibility, but correlated among those most likely to accept responsibility).

38. *See* BATSON, *supra* note 32, at 177, 181, 186, 199; EISENBERG, *supra* note 32, at 201-03 (arguing that the relationship between self-esteem and helping behavior is complex, but in many situations high self-esteem is associated with altruism); KOHN, *supra* note 32, at 72-73 ("[C]ontented people are more likely to extend themselves to others: the rule is 'feel good, do good.' "); Berkowitz, *supra* note 32, at 80-83 (explaining that elevated mood from prior success can influence helpfulness); Dovidio, *supra* note 32, at 389-91 ("The results of many experiments involving a variety of subject populations, research settings, ways of inducing feelings, and types of helping situations have found that people who feel good, successful, happy, and fortunate are more likely to help someone else than are people who are not in a positive state or who feel bad, unsuccessful, sad, or depressed."); Staub, *supra* note 32, at 144-45 (suggesting that a moderately positive self-concept is associated with altruism).

39. *See generally* Roland N. McKean, *Economics of Trust, Altruism, and Corporate Responsibility*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 29, 42 (Edmund S. Phelps, ed. 1975) (arguing that it is unlikely that altruism could be harnessed to modify corporate behavior affecting health and the environment).

symptoms even if they do not affect a cure, at a cost that is low relative to the benefit provided.

The concept of harnessing altruism to improve corporate governance is new, even revolutionary.[40] As such, most of the article is devoted to explaining the problem and then exploring altruism and its causes, rather than discussing a specific reform proposal. The concrete proposal set forth toward the end of the article is intended to initiate a conversation, not end it. The intent is to stimulate discussion in a new direction on a very old and important problem. While the proposal hopefully represents an important first step toward using altruism to shape preferences in ways that improve corporate governance, the true measure of this article's success will be whether it provokes others also to investigate reforms employing an altruism-based approach.

Part I of the article discusses the rising problem with CEO compensation levels and structures. Part II describes ways in which boards of directors are captured by CEOs, highlighting the problem of the separation between ownership and control. Part III outlines different theories about the root causes of altruism in the psychology, economics, and sociobiology literature, and discusses situational factors that help induce altruistic behavior. Part IV puts forth a proposal for harnessing altruism—the Random Shareholder Committee—and presents several potential criticisms of the idea along with responses. Concluding this article are suggestions of some areas for future research.

I. THE EXECUTIVE COMPENSATION PROBLEM

This article is premised on the notion that by any reasonable measure, CEO compensation is both much too high and poorly structured. This statement begs the question, what constitutes a reasonable measure?

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40. Despite considerable efforts, the author and his research assistant were unable to find a single published article applying altruistic theory to problems of corporate governance prior to submission of this article. After submission, however, such a working article was released on the Social Science Research Network. *See* Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, UCLA School of Law, L. & Econ. Research Paper No. 03-8, 2003, *at* http:// papers.ssrn.com (last visited Sept. 2, 2003).

Normally, economists turn to the market as a valuation tool. Markets generally provide the best available indication of efficient prices, the prices at which goods and services will be allocated to their most highly-valuing users.[41] The natural question to ask, therefore, is why we cannot depend on the market in the executive compensation context as we do in most others. No one seems terribly concerned, for example, that Tiger Woods or Madonna are overpaid, nor does anyone complain that their pay is not closely tied to their performance. Professional athletes have watched their compensation increase at much faster rates than that of CEOs. From 1980 to 1995, one study shows that CEO pay increased by 380%, while worker salaries increased by only 60%.[42] That study also indicates, however, that during the same period, NBA players saw their compensation rise by 640%, NFL players by 800%, and MLB players by 1000%.[43] Why raise an outcry over CEO pay, but maintain relative silence over salaries of professional athletes, whose pay has increased even more?

The important distinction between CEO compensation and the amount paid for most other services is that there is no well-functioning market for CEO compensation. For a market to reflect efficient prices, there must be competition among self-interested purchasers attempting to secure goods and services at the lowest cost possible. No such competition exists in the realm of CEO pay because the purchaser of the CEO's services—the board of directors—is aligned in important ways with the CEO. Instead of seeking the best talent for the least money, the board will often passively acquiesce to the desires of the current CEO both as to the CEO's retention and as to the CEO's compensation package.[44]

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41. *See generally* Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713, 721 (1996) ("[T]hrough the requirement of bargaining, we can be reasonably confident that property will change hands when and only when the change is efficient. For example, bargaining can ensure that my car will be transferred to another person when and only when he values it more highly than I do.").

42. *See* Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 6 (2000) (citing JAY W. LORSCH, COMPENSATING CORPORATE CEO'S: A PROCESS VIEW fig. II (Harvard Bus. Sch. Working Paper No. 99-013, 1998)).

43. *Id.*

44. *See infra* Part II (analyzing forces pushing toward board passivity).

In the absence of a well-functioning market for CEOs' services, other methods must be sought for evaluating whether compensation levels are excessive and poorly structured. In Section A, the article will examine absolute level and growth rate of CEO salaries, comparisons to worker salaries, comparisons to the compensation of CEOs in Europe and Japan, and correlation to performance as possible measures of appropriate CEO pay level and structure. In Section B, the article turns to the question of why policymakers should care about whether CEO pay packages are efficient. Finally, in Section C, the article briefly discusses some proposed methods of solving the executive compensation problem rooted in either the free market or regulatory schools and argues that these attempts appear unlikely to achieve their purpose.

A. *Is CEO Compensation Excessive?*

The level of CEO pay for the largest U.S. corporations continues to climb at dramatic rates.[45] U.S. CEO compensation is also high relative to their counterparts in Europe and Japan,[46] despite the fact that formal governance

45. *See* Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L. J. 59, 60-61 (1992) (during the 1980s, CEO compensation increased by 212% while earnings on the S&P 500 Index grew by only 78% and factory workers received only 53% raises); Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 10 (1993) (during the 1980s, CEO compensation grew 212%); Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 202 (1996) (CEO compensation rose 20.6% in 1993, 12.8% in 1994, and 10.4% in 1995); Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 123-24 (2000) (total CEO compensation for all 1900 firms listed in the ExecuComp database more than doubled from 1992 to 1998, and CEOs from S&P 500 firms' compensation rose more than 250%).

46. *See* Melvin A. Eisenberg, *The Compensation of the Chief Executive Officer and Directors of Publicly Held Corporations*, in CORPORATE GOVERNANCE INSTITUTE 103, 106-08 (ALI-ABA Course of Study, Oct. 7-8, 1999), *available in* Westlaw, ALI-ABA Database [hereinafter "Eisenberg I"] (explaining that while U.S. CEOs earn 200 times what factory workers earn, Japanese CEOs earn only about 20-30 times factory workers' salaries); Melvin A. Eisenberg, *A Brief Overview of the Problems Raised by Executive and Director Compensation*, IN CORPORATE GOVERNANCE: CURRENT AND EMERGING ISSUES 299, 301-02 (ALI-ABA Course of Study, Dec. 11-12, 1997), *available in* Westlaw, ALI-ABA Database [hereinafter "Eisenberg II"] ("[T]he evidence suggests that the total compensation of American CEOs, including base salary, bonus, long-term

structures in European and Japanese corporations are broadly similar to those of U.S. corporations and are arguably converging to the U.S. model.[47] Perhaps most troubling of all, CEO compensation seems poorly correlated with CEO performance, despite the geometric growth in the use of "performance-related" compensation in the past decade.[48]

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compensation and benefits and perquisites, is approximately twice as high as that of CEOs of comparable corporations in Japan, Germany, eight other west European countries, and Canada."); Loewenstein, *supra* note 42, at 4, 6 (explaining that U.S. CEOs appear to be paid more, but executive pay is difficult to measure outside the U.S.); Loewenstein, *supra* note 45, at 203 (explaining a 1996 study that showed U.S. CEOs earned an average of $1,085,000 while average CEOs in Great Britain earned $551,600, in Germany $537,000, in France $485,004, and in Italy $318,000). In 1990, average U.S. CEOs earned $2.8 million per year (120 times manufacturing worker's salary) while their counterparts in Germany earned $735,000 annually (twenty-one times factory worker's compensation) and CEOs in Japan earned only $310,000 (sixteen times factory worker's salary). Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1871 (1992) (reviewing GRAEF CRYSTAL, IN SEARCH OF EXCESS (1991)).

47. See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 454-59 (2001) (arguing that the major industrial countries' corporate legal systems are already broadly similar and are converging).

48. *See* Barris, *supra* note 45, at 65-66 (changes in stock prices may have nothing to do with CEO performance, accounting figures can be manipulated, and many executives are protected from decreased compensation in bad economic times); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction In the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 757 (2003) (firms use options that are not indexed to a relevant market and are therefore unrelated to CEO performance); Bogus, *supra* note 45, at 12 (citing a study which shows that while a 10% improvement in corporate profits correlates with a 24% increase in CEO compensation, a 20% decline corresponds with a 7.5% increase in CEO compensation, and a 30% decline results in a 6.1% boost in pay); Mark A. Clawson and Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate With Performance*, 3 STAN. J. L. BUS. & FIN. 31, 32-33 (1997) (recommending indexed options because non-indexed options are not correlated strictly to management performance); Robert Dean Ellis, *Equity Derivatives, Executive Compensation, and Agency Costs*, 35 HOUS. L. REV. 399, 414 (1998) ("[P]erformance and pay do not seem to be strongly correlated."); Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 891 (1991) ("Recent research reveals a strikingly low correlation between the compensation of top managers and the economic performance of their companies."); Loewenstein, *supra* note 45, at 203-08 (citing a study indicating that the link between CEO pay and performance is "slight" and arguing that the CEO cannot take sole credit for any corporate gain); *cf.* Melvin A. Eisenberg, *Contractual Freedom in Corporate Law: Articles & Comments; The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1489-92 (1989) (arguing that while there is a

But is CEO compensation excessive? We can break the question down into several components: absolute level and growth rate, comparisons to worker salaries, comparisons to the compensation of CEOs in Europe and Japan, and correlation to performance.

Beginning with absolute levels and growth rates, at the start of the 1980s, the average CEO earned $624,996.[49] During that decade, CEO pay rose by 212%.[50] Far from regressing to the mean after such an increase, during the past ten years, CEO compensation has skyrocketed by 340%.[51] As a result, average CEO pay now approaches $11 million per year.[52]

Such growth rates might not trouble us if they reflected general prosperity. But worker salaries have consistently lagged far behind. During the 1980s, while CEO compensation grew 212%, factory worker salaries rose by only 53%.[53] The past ten years have seen this divide only widen. As CEOs garnered 340% increases, employees saw only 36% growth in their wages.[54] As a result, while at the beginning of the 1980s, CEOs earned roughly 42 times worker salaries,[55] they now make, on average, 411 times what factory workers make.[56]

The distortionary effect of the split between ownership and control on CEO salaries can also be seen in a comparison to the compensation of CEOs in Europe and Japan. In Europe—especially Germany—and Japan, the

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statistical correlation between pay and performance, "the argument that the interests of managers and shareholders are adequately aligned by executive compensation is descriptively inaccurate because the dollar amounts involved are trivial or immaterial"); Perry & Zenner, *supra* note 45, at 123 (unclear whether CEO pay is tied to performance); David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440 (2000) (discussing the dangers to incentives from hedging strategies); Yablon, *supra* note 46, at 1873 (CEO compensation is only slightly correlated to corporate performance). *But see* Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, 64 HARV. BUS. REV. 125, 127 (1986) ("As measured by the rate of return on common stock, a strong, positive statistical relationship exists between executive pay and company performance.").

49. *See* Barris, *supra* note 45, at 62.

50. *Id.* at 60.

51. *See* Byrne et al., *supra* note 1, at 72.

52. *Id.*

53. *See* Barris, *supra* note 45, at 60-61.

54. *See* Byrne et al., *supra* note 1, at 72.

55. *See* Barris, *supra* note 45, at 62.

56. *See* Byrne et al., *supra* note 1, at 72.

ownership-control split is far less evident, despite a broad similarity in formal corporate structures.[57] Corporations in those countries are considerably more dependent on a small group of banks for their working capital.[58] In contrast, U.S. corporations rely much more on external capital markets.[59] Banks functioning as internal capital sources can exercise control over their investments by threatening to withhold additional funds. In addition, European and Japanese banks and other institutional investors are far more likely to own large percentages of a single corporation's stock, enhancing both their incentive and ability to exercise control.[60] For example, in Germany, an average of 45% of outstanding shares in 42 of the largest 100 corporations are owned by three banks.[61] John Coffee has argued that European and Japanese institutional investors sacrifice liquidity in exchange for a large measure of control—a sacrifice U.S. institutional investors have not proven willing to make[62]—but as a result institutional investors in Europe and Japan do achieve a degree of unity between ownership and control, ameliorating the problems stemming from the separation of ownership and control.[63]

Not surprisingly, then, CEO compensation is markedly lower in Europe and Japan than in the U.S. The results of one survey indicate that at a time when U.S. CEOs earned an average of a little over $1 million, CEOs in Germany earned about $537,000, CEOs in France $485,000, and in Italy $318,000.[64] In 1990, when average U.S. CEO compensation approximated $2.8 million, Japanese chief executives earned only an average of $310,000, and German CEOs took in $735,000 per year.[65] These numbers reflected multiples of average industrial worker salaries in these

57. *See* Hansmann & Kraakman, *supra* note 47.

58. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1286-87 (1991).

59. *Id.*

60. *See* Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 987-89 (1993).

61. *Id.* at 988 (counting banks' direct stock holdings, the holdings of bank-operated mutual funds, and the proxy votes of shares held by the banks' stock brokerage operations).

62. *See* Coffee, *supra* note 58, at 1287.

63. *See* Gilson & Kraakman, *supra* note 48, at 877-78.

64. *See* Loewenstein, *supra* note 45, at 203.

65. *See* Yablon, *supra* note 46, at 1871.

countries of 120 for the U.S., 16 for Japan, and 21 for Germany.[66] More recent studies also indicate that U.S. CEOs earn about twice as much as their counterparts in Japan, Germany, and other west European countries, while industrial workers in the U.S. earn less than workers in almost all of these nations.[67]

Perhaps these gaps are explainable not only by differences in ownership/control structures, but also by a difference in talent. U.S. CEOs might earn their greater compensation by producing better performance for their corporations. If so, U.S. shareholders at least would have little reason to complain.

The numbers, however, do not support the thesis of a link between ability and compensation. To begin with a few dramatic examples, in 1999 Michael Eisner of Disney earned $576 million, Sandy Weill of Citigroup $167 million, and Douglas Ivester of Coca-Cola $57 million.[68] That year, while the S&P 500 Index rose approximately 19.5%,[69] the total shareholder return for Disney declined by 5%, for Citigroup sank 6.8%, and for Coca-Cola rose only 1.3%.[70]

More general statistics tell a similar story. Graef Crystal's studies have demonstrated that when corporations do well, CEO pay increases by a multiple of the corporation's improvement.[71] When corporations' fortunes decline, however, CEO compensation rarely follows suit.[72] When a company's profits increase by 10%, CEO pay rises by an average of 24%.[73] But a 20% *fall* in corporate profits correlates to an *increase* of 7.5% in CEO pay.[74] Even 30% declines in profits are accompanied by 6.1% raises for CEOs.[75] Only when corporate profits collapse by more than 70% do average CEO salaries fall.[76]

66. *Id.*

67. *See* Eisenberg II, *supra* note 46, at 301-02.

68. *See* Eisenberg I, *supra* note 46, at 106.

69. *See* E. S. Browning, *Driven by Tech Stocks, Nasdaq Has Best Gain of Any U.S. Market Ever*, WALL ST. J., Jan. 3, 2000, at R1.

70. *See* Eisenberg I, *supra* note 46, at 106.

71. *See* Bogus, *supra* note 45, at 12 (finding a 10% rise in corporate profits corresponds to a 24% increase in executive compensation).

72. *Id.* (stating that a decline in corporate profits still resulted in pay increases for CEOs).

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 12-13.

Crystal is a famous advocate for corporate reform, but Kevin Murphy, largely a defender of the current compensation system, has also found a reluctance to reduce CEO compensation when corporate fortunes sink. Murphy's data from 1975-1984 indicated that when a company's stock price declined over that period an average of 0% to 20% per year, average CEO compensation still increased by 5.3% annually.[77] Even when a company's stock price fell by an average of more than 20% per year, CEO pay still increased by .4%.[78] When share prices rose on average, the increase in executive compensation was higher, but generally not as high as the increase in share price: 8.3% when share prices rose from 0% to 20% annually, 9.6% when share prices rose an average of 20% to 40% per year, and 13.8% when share prices skyrocketed by over 40%.[79] In sum, executive compensation seems poorly correlated to important measures of corporate performance.

B. *Does Excessive Executive Compensation Matter?*

Even if executive compensation is excessive and/or poorly structured to encourage CEOs to strive for the best corporate performance, why should shareholders care? Some well-respected scholars have argued that shareholders should remain indifferent to the amount of CEO pay, since even the largest packages seldom total very much on a per share basis.[80] The CEO compensation system may be troubled, but the impact on individual shareholders is arguably minimal. After all, even if CEOs of the largest corporations were paid $100 million per year, that would often amount to only pennies per share. The most

77. *See* Murphy, *supra* note 48, at 126.

78. *Id.*

79. *Id.*

80. *See* Loewenstein, *supra* note 42, at 11 (arguing that the amounts spent on executive compensation are immaterial); Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 726 (1995) (contending that the amount spent on CEO pay is not an important shareholder issue, in part, because eliminating such pay entirely would add only a miniscule percentage to shareholder returns). For example, the $123 million per year paid on average to Michael Eisner from 1996-2002 translates to about $.06 per share when divided by Disney's over 2 billion common shares outstanding. Similarly, Larry Ellison's one-time compensation of $706 million amounts to $.13 for each of the over 5.2 billion Oracle common shares outstanding. *See* Byrne et al., *supra* note 1, at 70; Condon, *supra* note 5, at 112.

successful public corporations frequently have hundreds of millions, if not billions, of shares. For example, IBM has 1.7 billion shares outstanding, Microsoft has 5.4 billion, Pfizer 6.1 billion, and General Electric 9.9 billion. With so many shares, even a payment of $100 million represents less than $.10 per share for IBM, and only a little more than a penny per share for G.E.

Such arguments miss the mark entirely. Dividing a cost by a sufficiently large number will always make it appear insignificant, but that tells us nothing about the significance of the total sum. For example, in 1992 the total budget of the United Nations was approximately $10.5 billion.[81] This number may appear impressive at first glance, but represents only $1.90 per person alive at that time. In other words, the citizens of the world each spent less on the U.N. than the cost of a single copy of the Sunday *New York Times*. The amount on a per capita basis appears trivial, but is this an argument for more funding or less? One could argue that a cut in funding of a dime per person is insignificant, but that would translate to a reduction of over $550 million, more than the U.N. spent on world health, the environment, science and technology, policy making, political affairs, or trade and development that year.[82]

The discussion should focus on total amounts, not meaningless comparisons to the corporation's earnings, size, or number of shares outstanding. Otherwise, we are left with the rather ridiculous conclusion that shareholders of sufficiently large corporations should not care if the company pays more than necessary for a factory, raw materials, land, intellectual property, or any other factor of production. The fact that there is only one CEO so that that officer's salary must swell to gargantuan proportions to appear meaningful when measured against the size of the corporation is simply not an argument that proves that any particular salary is reasonable.

There are many reasons to believe that excessive compensation poses a serious problem. First, excessive payments to the CEO signal potentially serious corporate governance problems. A board of directors that cannot

81. *See* Nationalism vs. Internationalism, *United Nations Budget*, *at* http://www2.sunysuffolk.edu/westn/unbudget.html (last visited Aug. 27, 2003).

82. *Id.*

restrain the CEO on pay issues may also be failing to monitor and control the CEO in areas of undisputed significance, such as accounting, mergers and acquisitions, and long-range business strategies. We can expect the markets to pay increasing attention to such issues after the recent round of corporate accounting scandals.

Second, pay that is not well-correlated to the CEO's performance will fail to induce appropriate incentives. Pay packages should be designed to motivate CEOs to achieve shareholders' goals. Large salaries that are not tied to those goals will only render CEOs increasingly independent of shareholder concerns.

Third, the market recognizes the importance of an expense that represents a few pennies per share. Company reports that quarterly earnings will miss targets by that amount or must be reduced by that amount sometimes result in large declines in stock price.[83] The consequences for individual shareholders, therefore, reaches beyond any marginal decrease in dividend payments.

Fourth, CEO compensation already can constitute a significant percentage of corporate profits, at least during troubled times. If CEO pay continues to grow at recent rates, the impact on corporate profits will eventually become not only significant but substantial. If the growth rate of the past ten years persists, average CEO compensation for the largest U.S. corporations could approach $50 million per year a decade from now, and the most generous packages could run into the billions.[84] At the highest levels, CEO compensation may begin to absorb

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83. For example, on December 3, 2002, Walt Disney Co. revised its quarterly earnings to reflect the dismal performance of the animated film "TREASURE PLANET." Earnings were reduced by two cents per share. Disney's stock fell some 9% during the twenty-four hours after the announcement. *See* Bruce Orwall, *Disney Revises Profit Downward As Movie Flops*, WALL ST. J., Dec. 4, 2002, at A3, A8; CNN Money, *Markets Can't Shake Losses*, *at* http://money.cnn.com/2002/12/04/markets/markets_newyork/index.htm (last visited Sept. 21, 2003).

84. CEO compensation grew at approximately 340% during the past ten years. *See* Byrne et al., *supra* note 1, at 72. Current average compensation for CEOs of the largest U.S. corporations is $11 million per year, *id.*, with the largest packages exceeding $700 million. *See* Gary Strauss, *Companies Take Action To Regain Investor Trust; As Image Of Big Business Turns Negative, Firms Initiate Change*, U.S.A. TODAY, July 17, 2002 at A1 (stating that Oracle CEO Larry Ellison cashed in options for a $706 million gain in 2001).

most or all of corporate profits, even for well-performing companies.

Fifth, enormous CEO pay packages represent large opportunity costs for corporations. The tens or hundreds of millions sometimes devoted to paying a single chief executive could instead be used to build a new factory, hire hundreds of lower-level employees, or engage in promising research and development projects.

Sixth, and finally, news reports of the enormous pay CEOs receive may undermine worker morale at all levels of the corporate hierarchy, especially as the gap between executive and worker pay accelerates. Declines in worker morale may lead to declines in productivity, damaging corporate profits.

In short, excessive and poorly structured CEO pay should matter a great deal to shareholders because it affects shareholder returns both directly, through opportunity costs and poor management incentives, and indirectly, through market and employee analyses of the meaning of such pay packages for corporate governance.

C. *The Need for a New Approach*

This article is hardly the first to point out that there may be a problem with executive compensation.[85] Previous attempts to solve the problem can be broadly divided as embracing one of two philosophies: the free market approach or the regulatory approach. While both of these approaches have put forward proposals with some promise, neither seems likely to solve the problem entirely. A new approach is therefore necessary.

The free market approach is characterized by a belief that the market will, on its own, achieve an efficient level and structure of executive compensation. Self-interested managers and directors, in a quest to boost their company's stock price, thereby directly or indirectly enhancing their pay and reputation, will structure their own compensation efficiently. Rational investors will perceive that managers are properly motivated through their compensation packages and not absorbing an inefficient level of the company's profits. These investors will then value the company more highly, and pay more for its stock, because they will

85. *See supra* notes 45-79 and accompanying text.

correctly believe that the company is and will be run efficiently. The most important examples of proposals employing the free market approach include greater reliance on options as a compensation method[86] and institutional investors taking a more active role in corporate governance.[87]

In the past ten years, options have become the single most important component of CEO compensation.[88] An option gives the holder the right to buy a share of stock in the future for a fixed price, called the exercise price or strike price. The longer the term of the option, and the lower the strike price, the more valuable the option.[89] Strike prices are almost universally set at the market price the day the option is granted.[90]

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86. *See, e.g.*, Clawson & Klein, *supra* note 48, at 32 (discussing indexed options); Arthur H. Dean, *Employee Stock Options*, 66 HARV. L. REV. 1403, 1404 (1953) ("[S]ome investors prefer to own stock in a corporation in which management or at least the key personnel have a material stake in the ownership of the business, so that they will have greater incentive to conduct the business in a manner wholly consistent with the interests of the investors."); Michael W. Melton, *The Alchemy of Incentive Stock Options—Turning Employee Income Into Gold*, 68 CORNELL L. REV. 488, 501 (1983) ("Encouraging the management of business to have a proprietary interest in its successful operation will provide an important incentive to expand and improve the profit position of the companies involved."); Eric J. Wittenberg, *Underwater Stock Options: What's a Board of Directors to Do?*, 38 AM. U. L. REV. 75, 104-07 (1988) (suggesting methods for repricing options whose strike price is significantly above market due to a market decline).

87. *See, e.g.*, Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994) (proposing legal reform to improve institutional investor activism); Gilson & Kraakman, *supra* note 48 (arguing that institutional investors should appoint "professional directors" to corporate boards); and Roberta Romano, *Less Is More: Making Institutional Investor Activism A Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001) (recommending reforms to encourage institutional investor activism).

88. For S&P 500 firms, the salary portion of CEO compensation declined from 36% to 21% of total compensation from 1992-98. The option-based portion of CEO compensation increased from 22% to 38% from 1992-1998 in S&P 500 firms. *See* Perry & Zenner, *supra* note 45, at 131. *See also* Barris, *supra* note 45, at 64 (stating that options increased as a percentage of total compensation from 8% in 1985 to 31% in 1991).

89. *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 477 (Concise 8th ed. 2000).

90. *See* Bebchuk et al., *supra* note 48, at 817 ("An analysis of options granted to the CEOs of one thousand large companies in 1992 determined that 95 percent of the options were granted at-the-money, that is, with an exercise price equal to the company's stock price on the date of the grant.").

In theory, options align managers' incentives with those of shareholders.[91] Options become more valuable as the market price of the underlying stock increases because at the time of exercise, options are worth the spread between the strike price and the market price. The higher the market price, the larger the spread and the more valuable the options become. To the extent that shareholders are exclusively concerned with increasing the stock's market price, issuing large numbers of options to managers should infuse executives with the same concern.

Despite the intuitive appeal of this theoretical argument, options may not align incentives particularly well and may even disguise management's efforts to obtain excessive compensation. As Lucian Bebchuk, Jesse Fried, and David Walker recently pointed out in the *Chicago Law Review*, traditional options camouflage the economic rents being extracted by management.[92] Traditional options are exploited in several ways. First, options naturally tend to overcompensate executives. Options allow CEOs to benefit from general market increases having nothing to do with the company's individual performance, without suffering from market downturns.[93] Very few companies employ options that are indexed to the relevant market sector. Worse yet, companies sometimes decrease options' strike price when the company's share price declines, but almost never increase the strike price when the stock market as a whole is rising.[94]

Second, options facilitate efforts to rationalize excessive CEO salaries. When the stock market is rising, board

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91. *See* PINTO & BRANSON, *supra* note 20, at 214.

92. Bebchuk et al., *supra* note 48, at 756.

93. *Id.* at 797-98 ("[C]ompensation based on absolute share price performance rewards managers even when the managers' efforts have not contributed to the share price increase. In particular, the share price increase might be driven solely by factors external to the firm—such as changes in the economy that benefit the firm's industry or interest rate declines that benefit the market as a whole."). The authors cite a study that found general market conditions account for 70% of a stock's performance. *Id.* at 797.

94. Brenner, Sundaram, and Yermack examined the S&P ExecuCom database for 1992-95. Of the 806 cases they discovered in which boards reset option prices, Brenner et al. found that the strike price was increased in only two cases, or about .25%. On average, exercise prices were reduced 39%. This occurred during a period in which the S&P 500 Index rose by about 50%. One would expect the incidence of strike price resetting to be even higher in down markets. *Id.* at 821-22.

members can argue that management is only doing well because shareholders are prospering. When share prices decline, however, directors can easily find ways to justify repricing options—resetting the strike price to a lower level. For example, the board might contend that the decline is due to general market conditions, not the CEO's mismanagement. Or directors might argue that failing to reprice the options will eliminate the CEO's performance incentive, perhaps inducing mismanagement or at least CEO slacking.[95]

Finally, traditional options tend to fly under investors' radar screens. Corporations traditionally have not been required to deduct options' value as expenses, so their impact on quarterly profits has been buried in footnotes in the company's financial statements.[96] It increasingly looks as though this may now change, however. In April of 2003, the Financial Accounting Standards Board ("FASB") agreed that companies should begin expensing options.[97] Although a dispute over how to value options will likely delay final regulations until the third quarter of 2004, about 20% of the companies in the Standard & Poor's 500-stock index have begun expensing options voluntarily.[98]

Thus, although options theoretically align managers' incentives with those of shareholders, in fact they have been used as a tool to overcompensate managers by rewarding executives for general market increases having nothing to do with their efforts, failing to hold CEOs

95. *See* Yablon, *supra* note 46, at 1878-79 ("[A]ny poor performance or reversal in corporate fortunes can be attributed to some external event: a downturn in the economy, undervaluation of the corporation's stock by the market, rising prices for needed raw materials, a weak dollar, a strong dollar, unfair foreign competition, for example.").

96. Prior to 1995, under Opinion 25 of the Accounting Principles Board, corporations were not required to report options as expenses so long as the option was technically valueless (because the exercise price was set above the market price) on the grant date. In 1992, the Financial Accounting Standards Board suggested expensing options but retreated in the face of heavy opposition from the financial community and from Congress. Ultimately, in 1995, the FASB passed SFAS 123, which grants corporations a choice between expensing options in the income statement or disclosing their value in a footnote. *See* Clawson & Klein, *supra* note 48, at 35-36.

97. *See* Lingling Wei, *Major Companies Will 'Road-Test' Options Standard*, WALL ST. J., Sept. 30, 2003, at A17.

98. *See* Lingling Wei, *Option-Expense Rule Is Put Off*, WALL ST. J., Sept. 11, 2003, at B2.

accountable for declines in the company's stock price, and masking the amount of compensation.

Other performance-based structures advocated by adherents of the market approach are similarly subject to manipulation. For example, Charles Elson has advocated replacing options with restricted stock, stock that cannot be sold while the recipient is employed with the company.[99] While Elson has focused on payments to directors, similar principles could apply to paying executives. Restricted stock solves some of the incentive and monitoring problems associated with options. Unlike options, restricted stock generally cannot be sold until the executive leaves the company. Directors and executives paid in restricted stock therefore would not have an incentive to artificially inflate the share price over the short term, since they would not be able to cash in their stock until some time after they leave the company.[100] Also, restricted stock must be expensed when issued, unlike traditional options.[101]

But restricted stock fails to solve two problems with options: (1) they make justifying enormous salaries too easy; and (2) they reward recipients for rises in the stock price that have nothing to do with how particular directors and executives have managed the company. Also, under a restricted stock compensation plan, some incentive problems remain. Corporate leaders will retain an incentive

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99. *See* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 690-92 (1995) [hereinafter "Elson I"] (suggesting that directors should be paid in restricted stock); *see also* Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 981-83 (1993) [hereinafter "Elson II"]; Charles M. Elson, *Director Compensation And The Management-Captured Board—The History Of A Symptom and a Cure*, 50 S.M.U. L. REV. 127, 164-73 (1996) [hereinafter "Elson III"]; Murphy, *supra* note 80, at 738 ("[Restricted stock] continues to be one of the most effective vehicles for providing both incentives and compensation to managers.").

100. *See* Elson III, *supra* note 99, at 130-31; Elson II, *supra* note 99, at 985 ("To prevent the quick liquidation of these stock payments and consequent loss of equity-based incentive, the stock awarded must be restricted as to resale during the individual's directorship.").

101. *See* Michel R. Flyer, *Employee Benefits And Executive Compensation*, in TAX AND BUSINESS PLANNING 359, 389 (ALI-ABA Course of Study, May 9-11, 1991), *available in* Westlaw, ALI-ABA Database ("If the restricted stock is provided to the employee in recognition of his past services, the employer should treat the compensation cost attributable to the grant of restricted stock as an expense in the period of grant.").

to deflate the share price just before their restricted stock is issued to them.

In addition, awards of restricted stock actually worsen some incentive problems. Officers paid in restricted stock face greater risk: unlike most public shareholders, they cannot diversify the bulk of their holdings to protect themselves from non-systemic risks.[102] Although this is also true to some extent with options, restricted stock increases the risk because the time horizon for cashing in restricted stock will be much longer than is typical for options. Executives can be expected to attempt to moderate this risk either through derivative trading (which if permitted will eliminate the positive incentive effects of restricted stock) or through corporate acquisitions that transform the corporation into a diversified investment vehicle, something that will generally be against the interests of diversified shareholders.[103]

The free market school has also argued that institutional investors will eventually solve problems—such as those with executive compensation—that stem from the split between ownership and control in public corporations.[104] Unlike most other types of shareholders,

102. Non-systemic risks are those that do not permeate through all companies. For example, the risk of excessive rainfall is a non-systemic risk. The extra rain will benefit umbrella companies, but hurt suntan lotion manufacturers. It is difficult to imagine a pure systemic risk. As Shakespeare wrote, it is "the ill wind that blows no man to good." WILLIAM SHAKESPEARE, HENRY IV PART 2, ACT 5, SCENE 3, *in* THE RIVERSIDE SHAKESPEARE 920 (G. Blakemore Evans ed., 1974).

103. *See* Ellis, *supra* note 48, at 403-05 (pointing out the problems associated with both permitting and barring derivative trading by executives).

104. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice,* 39 U.C.L.A. L. REV. 811, 815-16 (1992) (suggesting benefits to greater institutional investor monitoring outweigh dangers); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117, 176-78 (1988) (advocating reforms to facilitate institutional investor monitoring); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation,* 1989 WIS. L. REV. 881, 882-83 (1989) (proposing to grant control of proxy solicitations to a committee of the corporation's largest shareholders); Gilson & Kraakman, *supra* note 48, at 880 (arguing for having institutional investors elect professional directors); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism,* 136 U. PA. L. REV. 1, 63-64 (1987) (proposing changes in the tax code to shift institutional investors' focus to the long-term); *cf.* Robert G. Vanecko, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance,* 87 NW. U. L. REV. 376, 378 (1992) (arguing that changes in the securities laws to facilitate

institutional investors, such as mutual funds, private and public pension funds, banks, and insurance companies, typically own large amounts of stock.[105] These entities possess the potential to reunify ownership and control. Institutional investors may own large enough blocks of a company's stock to exercise real control, especially if they act in concert. Moreover, concentrated stock ownership may mean that the rewards that come from close monitoring of corporate activities outweigh the associated costs. As a result, institutional investors should possess a strong incentive to oppose any attempt by the CEO to act contrary to the shareholders' interests.

Unfortunately, this theory has often not borne out well in practice, in part because of two popular investment strategies, diversification and indexing. Most institutional investors diversify their holdings to reduce risk exposure.[106] Dividing investments among many different companies limits the consequences of a disaster suffered by any single corporation. But by limiting their investments in any one company, institutional investors also sharply reduce their incentive to monitor any particular corporation's management.[107]

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institutional investor activism are not necessary or advisable, in part because institutional investors are already often successful in influencing management).

105. *See* EISENBERG, *supra* note 89, at 118.

106. *See* Bogus, *supra* note 45, at 42 (finding that institutional investors diversify widely; even CalPERS seldom owns more than 1% of a company's outstanding shares); Thomas A. Smith, *Institutions and Entrepreneurs In American Corporate Finance*, 85 CAL. L. REV. 1, 18-20 (1997) (explaining institutional investors diversify to reduce risk (variance on returns) of investments); Ralph K. Winter, *On 'Protecting The Ordinary Investor,'* 63 WASH. L. REV. 881, 886-87 (1988) (suggesting that institutional investors protect themselves "from systemic and unsystemic risk through diversification").

107. *See* Stephen Thurber, *The Insider Trading Compensation Contract as an Inducement to Monitoring by the Institutional Investor*, 1 GEO. MASON L. REV. 119, 128 (1994) ("[W]hether because of trading practices or liquidity concerns, many institutional investors prefer taking small positions, often for short periods of time. Both small positions and short holding periods make significant returns from monitoring less likely. Small positions are unlikely to benefit from monitoring because of cost problems; positions held for short periods are unlikely to benefit from monitoring because of ineffectiveness of monitoring during the holding period. In either case, monitoring has insufficient practical benefits for the trading and liquidity-oriented institutional investor.").

Many institutional investors now also employ indexing for part or all of their equity investments.[108] Indexing involves buying stock in all of the companies in a particular sector index or in the market as a whole, often weighted according to market capitalization. Academic studies have asserted that in the long-term, the vast majority of investors who choose individual stocks will underperform the relevant market index.[109] An additional advantage of indexing is that it eliminates the need for expensive research on individual corporations. In other words, institutional investors who practice indexing need not monitor corporate behavior and, therefore, will not want to bear the expense of an active role in managing the corporation.[110]

Another reason institutional investors may not prove an effective panacea is that institutional investors often have close ties to the corporations in which they invest.[111] Institutional investors include private and public pension funds, mutual funds, insurance companies, and banks. With the exception of public pension funds, all of these entities may seek business from the same companies whose stock they own. A private pension fund, for example, may invest in a manufacturing corporation and also attempt to secure that corporation's employee pension account. Banks, mutual funds, and insurance companies may face similar conflicts of interest. Rather than risk potentially lucrative new business, conflicted institutional investors may cheerfully permit executives to pay themselves exorbitant

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108. *See* John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 860 (1994); Vanecko, *supra* note 104, at 408-09.

109. *See* Richard H. Koppes & Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing*, 20 J. CORP. L. 413, 440-41 (1995) (highlighting that the efficient capital market hypothesis suggests that active investors rarely earn greater returns than passive investors in the market as a whole); BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 373 (1999) ("The Standard & Poor's 500-Stock Index, a composite that represents 75 percent of the value of all U.S.-traded common stocks, beats most of the experts over the long pull."); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, 81 VA. L. REV. 611, 664 (1995) ("Active funds incur much higher trading and management costs than passive funds and on average earn lower returns than either passive funds or the market as a whole.").

110. *See* Vanecko, *supra* note 104, at 408-09 (explaining the disincentives to monitoring faced by indexed investors).

111. *See* EISENBERG, *supra* note 89, at 118.

salaries, reasoning that the resulting new business easily offsets any loss suffered by the investor's equity stake.

Finally, institutional investors are themselves corporations, run by CEOs who desire large compensation packages. Deflating the market for executive compensation runs directly counter to these officers' interest. The more CEOs at comparable corporations receive in compensation, the easier it will be to justify increases in salary packages for the heads of institutional investors. The converse is also true. Institutional investors cannot argue for reductions in the packages of heads of other corporations without being hoisted by their own petards, facing similar contentions regarding their own salaries. The placement of CEOs of other corporations on the board of institutional investors only makes this problem more obvious.

Public pension funds, in contrast, need not seek business from the companies in which they invest. In addition, public pension funds answer to political institutions, which often prove more sensitive to governance problems than do the shareholders of banks, mutual funds, or the corporations that hire private fund mangers. For these reasons, public pension funds such as CalPERS often play an active role in demanding governance reform. To take just one recent example, public pension funds led the movement calling for former New York Stock Exchange Chairman Dick Grasso's resignation.

In summary, although institutional investors own large amounts of stock, investment strategies such as diversification and indexing sharply reduce the likelihood that their investments will be sufficiently concentrated to make close monitoring and/or control worthwhile. Even if this were not the case, private institutional investors' ties to the corporations in which they invest, and the conflict of interest of these institutions' CEOs on compensation issues, combine to undermine institutional investors' effectiveness in reunifying ownership and control in the executive compensation context. Nevertheless, public pension funds do sometimes successfully advocate for governance reform, and greater attention should be devoted to energizing them.

The market approach contains tremendous intuitive appeal, but the concrete recommendations implemented thus far have failed to achieve their promise. Perhaps scholars will invent new devices that will better harness the power of markets—and more successfully avoid market failures—to induce managers to voluntarily select efficient compensation packages. But any such devices will need to overcome the powerful incentive of managers to circumvent the imposed safeguards so that they may secure for themselves a greater share of the corporation's wealth. So long as the managers of public corporations do not entirely (or even mostly) own those corporations, the conflict between managers' and owners' incentives will remain, and the market approach will continue to face challenges that at the moment appear nearly insurmountable.

Adherents of the regulatory approach argue that the problems with executive compensation can be corrected by regulation that overcomes market failures.[112] Selfish, rational shareholders and directors may lack sufficient information, predictive ability, or incentive to reach the socially optimal result through unmanaged competition.[113] Moreover, human rationality is bounded, subject to numerous heuristics and biases that warp perceptions of which choices are strategically correct.[114] As a result, regulation is sometimes necessary to force the disclosure of information, structure appropriate incentives, or protect market participants from their own lapses in rationality. The two dominant proposals employing the regulatory approach are attempts to obtain greater court supervision of executive salaries and efforts to regulate compensation directly.

Courts have historically proven reluctant to intervene in executive compensation decisions. Simply put, directors and executives of public corporations face little or no real threat of liability. The courts have developed doctrines that allow review of only the rarest case, if any. Claims of excessive compensation—like most claims based on poor decisions by management—belong to the corporation, so irate shareholders must launch a derivative action to obtain relief.[115] But derivative actions are very difficult to launch. The shareholder plaintiff must first either demand that the

112. *See* PINTO & BRANSON, *supra* note 20, at 113.

113. *See generally id.*

114. *See* Jolls et al., *supra* note 27, at 14-15.

115. *See* Brehm v. Eisner, 746 A.2d 244, 253-64 (Del. 2000) (analyzing excessive compensation claims as derivative); Bender v. Ferro, 448 N.Y.S.2d 666, 667 (1st Dep't 1982) (asserting claim that corporation paid managers excessive salaries is derivative).

board cause the corporation to launch the suit, or demonstrate that such demand is excused because futile.

To qualify under the futility prong under Delaware law,[116] plaintiffs must allege particularized facts that create a reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[117] For the first prong, the court determines whether there is a reasonable doubt that business judgment rule protection will be available to the board.[118] Merely naming the directors in the suit is insufficient to create futility; the directors must bear a substantial chance of personal liability.[119] Under the second prong, the court must consider whether the challenged transaction is likely to pass the business judgment rule test. Since the business judgment rule test only requires that the directors have made an informed, deliberative decision that is not grossly negligent,[120] compensation decisions will rarely flunk.

Even those lucky plaintiffs who somehow make it past the demand requirement remain unlikely to obtain relief. Compensation decisions, like other business decisions by the board, are evaluated under the business judgment rule.[121] So long as the board has taken the formulaic procedural steps to pass the business judgment rule, the compensation decision will pass. Short of fraud or self-dealing, the only exception to business judgment rule protection is the waste standard.[122] But to meet this standard the shareholder must prove that the disinterested,

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116. The article primarily discusses Delaware law because the majority of public corporations are registered in Delaware and therefore subject to Delaware law for internal governance issues. *See* EISENBERG, *supra* note 89, at 68.

117. *See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984), *overruled on other grounds*, *Brehm*, 746 A.2d at 253-54 (overruling on the scope of review of the appellate court).

118. *See Aronson*, 473 A.2d at 814.

119. *Id.* at 815 ("However, the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.").

120. *Id.* at 812; Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

121. *See Brehm*, 746 A.2d at 262 n.56.

122. *Id.*

non-fraudulent, non-negligent board authorized "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[123] As former Chancellor Allen has stated, such claims, like the Loch Ness Monster, are so rare as to possibly be non-existent.[124]

Though courts have historically been reluctant to supervise compensation decisions in public corporations, legislatures could by statute lower the standard of review. Charles Yablon, for example, has advocated a wider role for courts in this area.[125] But such legislation seems unlikely to improve matters. As Mark Loewenstein has pointed out, coming out with a lower standard of review that would force courts to evaluate executive compensation would likely flood the courts with litigation and make judges the primary decision-makers on compensation issues.[126] And as Ronald Gilson has argued, courts seem unsuitable monitors of compensation decisions.[127] They have little relevant expertise, and any standard of decision will of necessity be rather amorphous, like Yablon's proposed "reasonable in relation to the corporate benefits expected."[128] The decisions are therefore likely to be inconsistent and unpredictable, making it difficult for boards to function. Moreover, if directors become liable for making poor, multi-million dollar compensation decisions, it will likely become difficult or impossible to find qualified people willing to serve as directors.

In summary, because courts have historically proven unwilling to impose liability on directors except for gross

123. In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998), *aff'd in part and rev'd in part on other grounds sub nom.*

124. *See* Steiner v. Meyerson, C.A. No. 13139, 1995 WL 441999, at *5 (Del. Ch. 1995). *But see* Sanders v. Wang, 1999 WL 1044880 (Del. Ch. 1999) (denying a motion to dismiss a waste claim in an executive compensation case).

125. *See* Yablon, *supra* note 46, at 1896-1906 (arguing for a standard demanding that compensation be reasonable in proportion to the benefits expected).

126. Loewenstein, *supra* note 45, at 211.

127. *See* Ronald J. Gilson, *Executive Compensation and Corporate Governance; An Academic Perspective*, in 24th Annual Institute on Securities Regulation 647, 672-74 (PLI Corporate Law and Practice, Course Handbook Series No. B4-7017, 1992) ("Courts are the least suitable monitor of compensation decisions.").

128. Yablon, *supra* note 46, at 1897.

failures to supervise management, and because any attempt to involve courts in such supervision is likely to produce more harm than good, liability, like director compensation packages, fails to engender in directors an incentive to monitor corporations closely and to oppose management when appropriate.

The other popular method of employing the regulatory approach to the problem of executive compensation is to regulate that compensation directly by statute. The simplest form of such regulation would be to impose upper limits on executive salaries. These limits could take the form of absolute ceilings, or they could be structured as a function of some relevant corporate statistic, such as a fixed multiple of the lowest-paid worker in the company.

The problem with such direct regulation is that it tends to be both underinclusive and overinclusive. Compensation ceilings (of either form) are underinclusive in that they tend to have a justificatory effect for salaries that were previously below the set limit.[129] The law implicitly sends a message that compensation below the ceiling is acceptable, regardless of its appropriateness under other measures such as relationship to corporate performance.[130] Compensation ceilings are also overinclusive in that some chief executives may be worth more than the ceiling permits.[131] Preventing corporations from paying these managers their true value would distort the market for managers, a market which, as argued above, is already deeply troubled.[132]

The most recent effort to regulate executive salaries directly was the passage of Section 162(m) of the Internal Revenue Code under the Clinton Administration.[133] This law presents an illustrative case study of the problems inherent in direct regulation of executive salaries. Section 162(m) prohibits corporations from deducting certain

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129. *See* Graef Crystal, *Slim Fast for Corporate Fat Cats: Why Not Let Shareholders Vote on Top Executives' Pay Packages?*, WASH. POST, May 16, 1993, at C2 ("If $1 million is a reasonable level of pay for the CEO of a high-performing company, then it is too high for the CEO of a poor-performing company. And if $1 million is a reasonable level of pay for the CEO of a poor-performing company, it is too low for the CEO of a high-performing company.").

130. *Id.*

131. *Id;* Elson II, *supra* note 99, at 958 (nothing is inherently wrong with salaries over $1 million); Loewenstein, *supra* note 45, at 218 ($1 million is both too high and too low).

132. *See supra* notes 45-79 and accompanying text.

133. *See* 26 U.S.C. § 162(m) (2002).

executives' compensation over $1 million except to the extent the compensation is based on performance.[134] The purpose of the statute was to discourage companies from paying executives excessive salaries unless they were tied to corporate performance and to end federal tax subsidies for compensation packages that exceeded the maximum guidelines.[135]

The overall effect of Section 162(m), however, was not to lower compensation but to change its form. In fact, in the two years immediately after 162(m) was passed, average CEO salary and bonus increased by more than 10%.[136] In addition, corporations responded to the new law by issuing more options to their executives.[137] While payment in stock options theoretically increases the sensitivity of pay to performance, options are incapable of distinguishing between the executive's own performance and that of the company or stock market as a whole.[138] Section 162(m) did not succeed in reducing executive compensation. Executives and corporations quickly found methods to circumvent the new restraints.

The regulatory approach to solving the executive compensation problem has struggled against executives' strong incentive to overcome any barriers erected. As with the market approach, scholars and policymakers may yet develop new forms of regulation that successfully curtail and restructure executive compensation in the face of executives' powerful resistance. So far, however, executives appear to have largely succeeded in avoiding the restraints of regulation.

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134. 26 U.S.C. § 162(m)(4)(C) (2002) (excluding from the salary cap "any remuneration payable solely on account of the attainment of one or more performance goals").

135. *See* Crystal, *supra* note 129, at C2.

136. *See* Loewenstein, *supra* note 45, at 219-20. *But see* Tod Perry & Mark Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, 62 J. FIN. ECON. 453 (2001) (contending that many million-dollar firms have reduced salaries as a result of §162(m) and the growth rate of executive compensation has slowed for the firms most likely to be affected).

137. *See* Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors*, 3 STAN. J. L. BUS. & FIN. 5, 6 (1997) (demonstrating that the number of executive stock plans and the number of shares reserved for such plans have exploded in past few years).

138. *See supra* notes 92-94 and accompanying text.

The market and regulatory approaches have both yielded many promising avenues of reform, some of which have been tried. Neither, however, has achieved notable success in solving the problem of the separation of ownership and control generally, nor the executive compensation problem in particular. For this reason, it is time to try a new approach as a supplement to the other two, employing the insights of behavioral economics and psychology in an attempt to modify human behavior.

Before turning to a discussion of altruistic theory, however, there is one component of the explanation of the executive compensation problem that requires further analysis: captured boards of directors.

II. THE PROBLEM OF CAPTURED BOARDS

Recall that the difficulty in evaluating the efficiency of CEO pay packages stemmed from the absence of an efficient market for CEO services. This market failure, in turn, is rooted in the tendency of boards of directors to acquiesce to CEO demands instead of bargaining for the best possible deal for the corporation. Earlier, the article asserted board passivity as a fact while postponing the analysis of why such passivity exists. The article turns to that question now.

Direct evidence of boards' failure to resist CEO demands is difficult to obtain. Board members can hardly be expected to confess to breaching their fiduciary duties on an interview form. Nevertheless, there is substantial indirect and anecdotal evidence in the form of results: boards rarely seem to oppose CEO-sponsored resolutions, particularly on executive compensation, short of a corporate crisis.[139]

139. *See* Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72, 73 (1990) ("[M]anagers dominate their boards by using their de facto power to select and compensate directors and by exploiting personal ties with them."), *quoted in* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 562 (2003); Elson II, *supra* note 99, at 942 ("The board is not representative of any one shareholder or shareholder group, but is picked by and responsive to the leading officers of the corporation."); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797 (2001) ("The dominant view in corporate governance theory today is that heavy emphasis on teamwork and

A number of factors tend to produce board passivity. These factors include problems of the selection and composition of boards, pressures on board members once they are appointed, directors' lack of resources, and particular issues with compensation decisions.

A. *Selection and Composition of Boards of Directors*

Unlike most democratic political elections, people running for a directorship in a public corporation rarely face opposing candidates. Instead, except for unusual situations such as a proxy fight, the number of nominations generally matches the number of open board slots.[140] The candidates' election, then, is little more than a formality. These candidates are selected by the board's nomination committee.[141] The CEO has tremendous influence on the nomination committee's decisions. Formally, the CEO sits on the nomination committee in a substantial number of public corporations.[142] In addition, the nomination committee is urged to consider the CEO's candidates.[143]

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conflict-avoidance marks a board that has been captured by its CEO . . . ."); Loewenstein, *supra* note 42, at 15 n.86 (citing other sources arguing that boards are captured by management).

140. See Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 38 (1990).

> Shareholders in large publicly held companies, while nominally empowered under state law to elect the directors who will represent their interests, are systematically deprived of two significant opportunities: they are neither permitted to play a meaningful role in the selection of directorial candidates, nor to choose among competitive candidates for scarce board positions.

Id. The lack of competitive director elections is in part because institutional shareholders face many obstacles to nominating their own directors, including a risk of liability for insider trading or short-swing profits, and because Rule 14a-8 prohibits director nominations in proxy solicitations. *See* Black, *supra* note 104, at 823-24.

141. *See* Barnard, *supra* note 140, at 38.

142. *See* Bogus, *supra* note 45, at 34 (citing survey with an admittedly small sample size that found 90-100% of all directorial candidates were recommended by the CEO); Perry & Zenner, *supra* note 45, at 135-36 (study by Anil Shivdasani and David Yermack found that only 77.5% of firms had nomination committees, and that CEOs sat on 32.5% of those nomination committees that did exist).

143. WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS § 3.06(b)(2) (6th ed. 1988) ("The nominating committee should . . . consider candidates for directorships proposed by the chief executive officer . . . .").

Informally, the nomination committee is likely to defer to the CEO's recommendations because of the pressures and resource constraints described below. As a result, in many cases the CEO will effectively hand-pick the board of directors, and will almost always exercise a great deal of influence on the selection process.

In part because of this influence, the board members chosen tend to be people who seem likely to defer to the CEO, who will allow the CEO free rein over the corporation's affairs. Although talented and experienced board members may yield sage counsel, they may also threaten the CEO's control over the company and ultimately his or her job security. As a result, as Warren Buffet has famously quipped, "There is a tendency to put cocker spaniels on compensation committees, not Doberman pinschers."[144]

The largest group of board members consists of chief executive officers of other large public corporations.[145] Because CEOs want their own companies' boards to remain passive, they have little incentive to oppose management's desires when they sit on boards of other corporations. This dynamic is particularly pervasive when boards are interlocking; that is, when two or more CEOs sit on each other's boards of directors. Interlocking boards render explicit the implicit reciprocity of passivity that exists whenever CEOs of other companies become directors.

A second popular source of board members is "insiders," officers of the company or various outside experts—such as lawyers, accountants or consultants—who do a great deal of work for the corporation.[146] The advantage of using insiders is that they start out already knowing a great deal about the company's operation, arguably making them more effective monitors. But this group is perhaps the most likely to defer to the CEO since insiders' careers depend on

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144. Keith Naughton et al., *The Perk Wars: As Jack Welch's Retirement Deal Sparks an Investor Backlash, Perks Could Become the New Stock Options*, NEWSWEEK, Sept. 30, 2002, at 44.

145. CEOs of other companies constitute some 63% of outside directors. *See* Gilson & Kraakman, *supra* note 48, at 875.

146. For example, Microsoft's eight-member board includes insiders Bill Gates, the company's Chief Software Architect, Steven Ballmer, the CEO, and Jon Shirley, the company's retired president and COO. *See* Microsoft PressPass, *Microsoft Board of Directors*, *at* http://www.microsoft.com/presspass/bod/ (last visited Sept. 21, 2003).

maintaining the CEO's good opinion. Increasingly, reform efforts have focused on excluding insiders from the board, or at least from certain key committees.[147]

A third group often appointed to boards consists of friends of the CEO.[148] The CEO's friends are also quite likely to defer to the CEO's lead in setting company policy. Having been appointed to a desirable[149] position out of friendship, they seem particularly unlikely to respond by questioning the CEO's policies.

Institutional investors constitute a fourth group sometimes represented on boards. In theory, institutional investors are the ideal board members because they may own significant amounts of the corporation's stock.[150] As a result, institutional investors should possess a strong incentive to oppose any attempt by the CEO to act contrary to the shareholders' interests. But, as explained above,[151] this theory has not borne out well in practice, in part because the popular investment strategies of diversification and indexing. These strategies encourage spreading the investor's capital among large numbers of companies,

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147. For example, in 1992 the Clinton administration succeeded in passing § 162(m) of the Internal Revenue Code, which effectively requires that the compensation committee of large corporations consist entirely of independent board members. *See* 26 U.S.C. § 162(m)(4)(C)(i) (1992) (permitting corporations to deduct performance-based compensation above $1 million if, *inter alia*, "the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors").

148. *See* Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75, 109 (1993) (stating that the boardroom is full of CEO's friends); Yablon, *supra* note 46, at 1881 (explaining that outside directors are generally friends of the CEO).

149. Board memberships are widely considered highly desirable positions because they demand little work for the compensation provided and are very prestigious. *See infra* Part II(B).

150. *See* Black, *supra* note 104, at 815-16 (arguing that benefits to greater institutional investor monitoring outweigh dangers); Conard, *supra* note 104, at 176-78 (advocating reforms to facilitate institutional investor monitoring); Dent, *supra* note 104, at 882-83 (proposing to grant control of proxy solicitations to a committee of the corporation's largest shareholders); Gilson & Kraakman, *supra* note 48, at 880 (arguing for having institutional investors elect professional directors); Lipton, *supra* note 104, at 63-64 (proposing changes in the tax code to shift institutional investors' focus to the long-term); *cf.* Vanecko, *supra* note 104, at 378 (arguing that changes in the securities laws to facilitate institutional investor activism are not necessary or advisable, in part because institutional investors are already often successful in influencing management).

151. *See supra* notes 104-10 and accompanying text.

greatly reducing the amount even the largest portfolios have invested in any single corporation. Without concentrated ownership, there is insufficient incentive for institutional investors to invest in monitoring or in active board membership.

A final group of board members are the true independents, frequently consisting of academics or prominent retired politicians, appointed to enhance the board's credibility.[152] These "celebrity" appointees may or may not have expertise relevant to their tasks as directors, but their fame in academia or government should provide an incentive to behave independently of the CEO. Celebrities can be expected to work to preserve their hard-earned reputation for integrity and intelligence. They risk this reputation if they meekly accede to the CEO's every desire. Nevertheless, short of a corporate crisis, even the celebrity directors face powerful incentives to bow to the CEO's will, as described in the next section.

B. *Temptations of Board Membership*

Why are board members—even celebrity board members—generally so deferential to the CEO? In part, this compliance is due to pressures inherent in the office. Simply put, the job of corporate director pays well, is steeped in prestige, requires relatively little time commitment, and often yields substantial benefits. Such plums are hard to come by, and, once achieved, difficult to relinquish. Since displeasing the CEO means risking one's position as a board member, we can expect most board members to oppose the CEO's desires only when the stakes are dramatic. When the company's future is at risk, if directors accede to poor decisions by the CEO they face a high likelihood of extremely negative publicity, multiple shareholder lawsuits, and perhaps even a proxy fight or hostile takeover attempt. But for more mundane issues—such as executive compensation—board members will rarely suffer material adverse consequences from

152. Examples abound. IBM's board, for example, includes Nannerl O. Keohane, the President of Duke University, and Charles M. Vest, the president of M.I.T.; former Secretary of State Henry Kissinger sat on American Express' board for some time; Sidney Poitier was, until recently, a Disney director; and former dean of Stanford Business School, Robert Jaedicke, chaired Enron's audit committee.

compliance, yet risk the loss of a comfortable, lucrative position if they resist. This dichotomy creates a powerful incentive for even the most independent director to rationalize a decision to vote with the CEO.

Compensation of directors of Fortune 1000 companies averages $116,000 per year; $152,000 for Fortune 200 corporations.[153] Director pay takes the form of a retainer plus fees paid for each meeting directors attend, on the order of $1000 per meeting, and for each special task they take on, such as chairing a committee.[154] Directors also receive stock options, sometimes in substantial amounts.[155] The Enron directors, to take an extreme example, were paid as much as $350,000 in cash, stock and options.[156]

Directors also frequently receive substantial benefits. Many corporations pay for various forms of insurance for their board members, including health, dental, disability and life insurance in addition, of course, to director and officer liability insurance.[157] Corporations also grant pension plans to some directors who have served several terms.[158] Further, directors may receive the right to decide where some portion of the corporation's annual charity will be donated.[159] For example, in 1995, American Express gave one of its board members—Henry Kissinger—the right to donate $500,000 to the charity of Kissinger's choice upon his death.[160]

Directorships may also lead to other opportunities. It is not uncommon for CEOs to hire directors as consultants for special projects.[161] Such consultancies can be incredibly lucrative, many times the director's cash compensation.[162]

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153. *See* Gary Strauss, *Companies Pony Up to Keep Directors; Board Seats Have Become Hot Seats,* U.S.A. TODAY, Nov. 21, 2002, at B1.

154. *See* David Phelps & Patrick Kennedy, *Due Diligence; Regulators, Stock Exchanges, and Investors are Placing More Scrutiny Than Ever... ON THE BOARD; Pay, Perks Vary at Minnesota Firms,* STAR TRIB. (Minneapolis-St.Paul), Aug. 11, 2002, at 1D.

155. *Id.*

156. *See* John A. Byrne, *No Excuses for Enron's Board,* BUS. WK., July 29, 2002, at 50.

157. *See* Elson III, *supra* note 99, at 147.

158. *See id.*; Eisenberg I, *supra* note 46, at 134-37.

159. *See* Eisenberg I, *supra* note 46, at 133.

160. *Id.*

161. *Id.* at 133-34.

162. In 1995, for example, American Express paid Kissinger $350,000 in annual consulting fees. *Id.* at 133.

There is currently, however, some movement to restrict directors' ability to receive consulting contracts.[163]

Board memberships may also lead to additional board memberships. Directors frequently serve on more than one board and, as previously mentioned, CEOs also frequently serve on the boards of other corporations. As a result, a new board member suddenly has access to a group of people in an excellent position to recommend him or her to additional boards. In addition, membership on the board of a major public corporation is an excellent credential in attempting to qualify for a position as the director of some other major public corporation.

Gerald Davis has traced the resulting connections among board members with startling results.[164] In a variation of the "Six Degrees of Kevin Bacon" game,[165] Davis investigated the interlinking of corporate boards by asking how many directors are required to connect any two corporations. For example, if Director A sits on the board of Corporation 1 with Director B, and Director B sits on the board of Corporation 2 with Director C, and Director C also sits on the board of Corporation 3, then Corporations 1 and 3 are linked in two steps. Davis discovered that, in 1999, 97.4% of all corporations in his sample group of 811 Fortune 1000 firms could be linked to Chase Manhattan in four steps or fewer.[166] One of the most "connected" directors, Vernon Jordan, served on nine boards with 106 other directors.[167]

Finally, although this benefit is impossible to quantify, board memberships are very prestigious. Large public corporations are, in a sense, the Ivy League of the business world. Membership in the governing body of such

163. *Id.* at 133-34 (explaining that American Express and W.R. Grace have adopted policies against awarding consulting contracts to directors).

164. *See* Gerald F. Davis et al., *The Small World of the American Corporate Elite, 1982-2001*, 1 STRATEGIC ORG. 301-26 (2003).

165. "Six Degrees of Kevin Bacon" is a game popularized by the internet in which players attempt to link random movie stars to Kevin Bacon through movies. For example, to link Kevin Bacon to Dustin Hoffman requires at most two degrees. Kevin Bacon appeared in A FEW GOOD MEN (Columbia Pictures 1992) with Tom Cruise, who co-starred with Dustin Hoffman in RAIN MAN (MGM 1988).

166. *See* Davis et al., *supra* note 164, at 320.

167. *Id.* at 304. The interconnectedness of boards is also the subject of the website www.theyrule.net, which permits users to explore how companies are connected through overlapping board members.

institutions cloaks directors in credibility that can be leveraged to obtain other positions in government or business.

Upon hearing of the tremendous benefits associated with board membership, one might think that corporate directorships are very demanding jobs. But the opposite is actually the case. The average corporate director spends less than 160 hours per year on board business, including travel time.[168] That equates to roughly three weeks of work.[169]

The tremendous tangible and intangible benefits of directorship contrasted with the relatively insignificant amount of work demanded produces powerful incentives to retain a membership position. I do not mean to argue that all corporate directors are bought and paid for management lackeys. But even directors of great integrity may find that arguments become more powerful when implicitly linked to munificent benefits. It would be naive to think that the rewards for compliance lurking in the background of every boardroom discussion have no effect on director decision-making.

C. *Board's Resource Constraints*

Further complicating independent directors' efforts to monitor the CEO are the resource constraints they face. These include limited time, staff, information, agenda, and, perhaps most importantly, incentive.

As just discussed, directorships are considered part-time work; board members of major corporations spend an average of 157 hours per year fulfilling their directorial

168. *See* EISENBERG, *supra* note 89, at 147 ("[O]utside directors spend an average of 157 hours a year on board matters, including preparation time and travel time."); *see also* Bogus, *supra* note 45, at 35 n.184 (citing a 1988 survey showing how directors spend about 108 hours per year on board-related activity, including travel time); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1481 (1984) (citing a 1982 survey demonstrating that directors of publicly held companies spend about 123 hours per year, including travel, on work as director).

169. Consider that it is quite common for a New York corporate lawyer to bill over 2400 hours per year or over 200 hours per month (assuming a few weeks of annual vacation). Even if 90% of hours worked are billable (a number that in my experience would be somewhat high), 157 hours translates into less than three weeks of work for a corporate lawyer.

duties.[170] Corporate officers, in contrast, invest the bulk of their work hours in corporate business. This time discrepancy grants an enormous advantage to officers in any dispute between management and the board. The CEO and other members of the management team have many times the work hours available with which to conduct market surveys, consult experts, formulate strategy, and create persuasive presentations. Management also enjoys the luxury of greater focus on the corporation. While other occupations take up the bulk of directors' time and attention, management's most important career priority remains the corporation.

This time advantage compounds when we add in the staff differential. The entire corporate hierarchy supports management's efforts, but directors generally do not have any staff at all devoted to their board-related activities.[171] The resulting ratio of total work hours available to management compared to the board's work resources will generally exceed 100:1 and could exceed 1000:1.[172] While the board could theoretically also draw on corporate employees, such employees are unlikely to be willing to oppose the management team that determines their employment futures, short of a looming change in control. The board could also hire outside assistance such as management consultants, but board members can be expected to feel some reluctance to hire large teams of outside experts, of a size capable of matching management's personnel advantage. Taking on the expense of what amounts to a

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170. *See supra* note 168 and accompanying text.

171. *See* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 609 (1982) (explaining that the Corporate Directors' Guidebook does not recommend regular staffing for non-management directors); *see also* Edward D. Rogers, *Striking the Wrong Balance: Constituency Statutes and Corporate Governance*, 21 PEPP. L. REV. 777, 793 (1994) ("[C]orporations and commentators have largely rejected proposals to provide staffs to boards of directors.").

172. Consider, for example, a corporation whose board consists of twelve outside directors, and whose management team employs 100 staff members. If the board members devote an above-average 150 hours per year to corporate business, they would have a total of 1800 work hours available to them annually. Even if the management staff works only 45 hours per week, the corporate officers could draw on 225,000 work hours, a multiple of 125. If we included all of middle-management in the corporate officers' side of the ledger, swelling their numbers to at least 1000 staff members in large corporations, the ratio would approximate 1250:1.

second management team demonstrates profound lack of trust in existing management. Given the likely impact of this message on both the equity markets and the board-management relationship, a rational board will take such an action only when faced with a corporate crisis.

Theoretically, the board is entitled to any corporate information it desires.[173] In practice, however, management controls the flow of information. Hostile corporate officers will often succeed in frustrating directors' efforts to obtain relevant data.[174] In addition, the board's limited numbers imply limited fields of expertise. Celebrity directors—who are often academics or former politicians—will be particularly likely to lack relevant knowledge and skills. In contrast, management already has in its employ numerous experts on the corporation's business. While the board could employ outside experts, outsiders will not have access to the same level of information that the management team will. Management will generally have the ability to manipulate the flow of information to its advantage.

Management can further deflect board opposition through its influence on the board's agenda. Since management commands superior knowledge of the issues facing the corporation, it would be reasonable for a board to defer to management's greater knowledge in deciding how to allocate its scarce time. By keeping the board's attention focused elsewhere, management may distract the directors from issues that threaten the officers' control.

Perhaps the greatest threat to the board's effective monitoring of management is the absence of any strong financial incentive for the directors to investigate or oppose management. Directors' pecuniary incentive to monitor the corporation could stem from either their pay packages or from the threat of liability. Neither has proven effective in instilling a sufficiently powerful incentive to oppose management. Directors' pay packages, even in the rare cases when composed entirely of stock in the corporation,

173. *See* 8 DEL. CODE ANN. tit. 8, § 220(d) (2001) ("Any director . . . shall have the right to examine the corporation's stock ledger, a list of its stockholders and its other books and records for a purpose reasonably related to the director's position as a director."); Henshaw v. Am. Cement Corp., 252 A.2d 125, 128 (Del. Ch. 1969) ("A director of a Delaware corporation has the right to inspect corporate books and records; that right is correlative with his duty to protect and preserve the corporation.").

174. *See* EISENBERG, *supra* note 89, at 147.

lack the magnitude to create adequate incentives. For example, imagine a director who has served on the company's board for ten years, earning $100,000 in the corporation's stock each year as payment. With some appreciation, the director might own as much as $1,600,000 in company stock.[175] This director owns a significant equity stake in the company, which should correspond to a powerful incentive to monitor management behavior. As the company flourishes, the value of the director's stock will increase.

The problem with this theory is that the director's economic interest in retaining his or her position will outweigh all but the most dramatic effects on this equity stake. The present value of $100,000 per year over the next ten years, assuming a discount rate of 5%, is nearly $800,000,[176] or just about half the director's equity stake. Suppose the corporation is faced with an important decision, and that the director believes that management's plan will result in a reduction in the corporation's stock price of 20%. Suppose further that, as argued above, managers will refuse to renominate any director that opposes their policies.[177] If the director decides to oppose management and succeeds, he or she will have averted a $320,000 loss. But that director will also lose the future stream of income from his or her position as a board member, a cost of nearly $800,000. Faced with this choice, a rational director will accede to management's desires, preferring a loss of $320,000 to a loss of $800,000, especially given the chance that a director who opposes management may lose his or her seat on the board while still failing to reverse management's policies, a $1,120,000 loss. Unless

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175. If we assume the stock appreciates steadily at 10% per year, then an income of $100,000 in stock per year for ten years would amount to just shy of $1,600,000, ignoring taxes and dividends and assuming the director never sells any of the stock acquired.

176. $$\sum_{n=1}^{10} [1/(1.05)^n]*100{,}000=772{,}173.5$$

177. It is rational for managers to dispose of directors who oppose their policies. Even if some particular policy advanced by an opposing director would benefit the corporation, the independence signaled by opposition may also apply to decisions on the manager's future employment with the company. From the CEO's perspective, it would take a rare combination of massive stock ownership by the CEO and tremendous benefits from some particular policy change to make such a truly independent board worth the risk to the CEO's job security.

the issue before the corporation is the sort of "bet the company" decision that could result in a decline (or increase) in the company's stock value of 50% or more, or a potential change in corporate control,[178] this hypothetical director will comply with management's wishes.

This example illustrates the notion that because the effect of any particular decision on a director's equity stake will rarely outweigh the director's interest in retaining his or her position, board members' pay packages will not generally succeed in encouraging rational directors to oppose management's interests.

D. *Compensation-Specific Problems*

Thus far, we have discussed why board members might generally tend to defer to management's decisions, in the absence of a corporate crisis. There are reasons to believe, however, that directors will be particularly likely to comply with the CEO's requests in the compensation context. Directors' incentives to resist management are weaker when making CEO compensation decisions, and such decisions are particularly easy to rationalize.

A rational CEO may care more about his or her own compensation than about any other corporate decision. It is hard to imagine any other area in which the CEO's interests are so directly at stake. In the arena of CEO pay, not only do the rewards of opposition appear small, but the risks are particularly great. CEOs are unlikely to forgive a director who suggests the corporation should be paying less for the chief executive's services. It is unlikely that the CEO's compensation package will appear nearly as important to the corporation as to the CEO. As a result, even truly independent and extremely conscientious board members may well feel their time and political capital are better spent fighting for favored business strategy decisions. More self-interested directors will surely shun the high-risk, low-reward strategy of resisting the CEO's compensation desires.

Moreover, directors can easily rationalize the amount of pay both to themselves and shareholders by using

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178. In the case of a change in control, the director's incentives will depend in part on the effect of the change on his or her future status as a board member.

compensation consultants or pay structures that appear performance-based. As part of the pay-setting process, many corporations involve compensation consultants. These consultants—who are most often hired by the CEO—compile compensation surveys, showing CEO pay scales at comparable corporations. No board of directors—and certainly no CEO—should believe that its corporation's chief deserves less than average pay; after all, boards hire CEOs because of their outstanding, well-above-average credentials. One can easily see how a tendency to pay even slightly above average salaries can quickly result in a dramatic ratcheting of the compensation of large corporation CEOs.[179]

Board members can also justify large pay packages by making most of the pay appear to be performance related, using tools such as options, without actually linking pay to management's performance. As explained above, however, options reward executives for the corporation's overall performance—or that of the relevant market sector—without regard to any particular manager's contribution to achieving that performance.[180] Options therefore function poorly as means to induce performance by individual managers. Paying executives in restricted stock poses similar problems.[181]

Board members therefore have numerous tools at their disposal with which they can satisfy CEOs' compensation demands while rationalizing both to themselves and to the shareholders the resulting overlarge payments. The ease of rationalization using apparently performance-based pay and employing compensation consultants, combined with the high-risk, low-reward nature of compensation challenges, can be expected to result in board members experiencing even greater reluctance to challenge CEOs in the compensation context.

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179. *See* Bebchuk et al., *supra* note 48, at 790 ("It is widely understood that the methodology of compensation consultants and boards in devising compensation plans results in a 'ratcheting up' of salaries."); Yablon, *supra* note 46, at 1878 ("It is not difficult to see how, in a world in which every CEO believes he should be paid at or around the seventy-fifth percentile of the range of compensation levels developed by the compensation consultant, a strong upward pressure on compensation will result.").

180. *See supra* notes 92-97.

181. *See supra* notes 98-102.

E. *CEOs Hired from Outside the Corporation*

Although the pressures just described warp the compensation-setting process for existing CEOs, and perhaps for CEOs promoted from within the company, what about CEOs hired from outside? An outside candidate has not selected the directors, nor has such a candidate had the time to develop relationships with the board members. Despite the absence of these advantages, there is data that suggests that outside candidates for the position of CEO succeed in negotiating higher compensation packages than inside candidates.[182] Kevin Murphy has argued that this data demonstrates the fallacy of the notion that boards are captured.[183]

To the contrary, this data is entirely consistent with the theory that boards are captured. First, the board members all possess a powerful incentive to please the person who will become the new CEO. If the existing board members wish to retain their positions, they must quickly establish relationships with the new chief executive. Paying the new CEO an extraordinary amount of money is a quick and easy method of creating goodwill. In fact, this dynamic may help explain why outside candidates are paid more than inside candidates: board members already have some relationship with inside candidates, so they do not need to pay inside candidates as large a "greeting gift." Second, the board members will have the same incentive to avoid antagonizing an outside candidate over compensation issues that may appear relatively unimportant items on the corporate agenda as they do to avoid angering inside candidates. Third, even if the board members are not friends of the outside candidate, many of the directors will still be CEOs with an interest in raising average CEO compensation. Finally, as Bebchuk et al. have argued, the flaws in the negotiating process with existing CEOs and inside candidates distort the market for CEO compensation generally.[184] Outside candidates must be lured away from

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182. *See* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 852-54 (2002).

183. *Id.*

184.

CEOs hired from the outside who at the time of their hiring are CEOs of other firms are likely to be using their power at those firms to companies where they already have established the advantages of entrenchment. They will rationally refuse to leave a company whose board they have captured unless paid a great deal more than they are earning already.[185]

This section has argued that boards are to a great degree captured by CEOs, making them largely biddable on executive compensation issues and setting up the market failure that generates the executive compensation problem. Now that the article has discussed the nature of the problem and the need for an alternative approach to solutions, it will next explore altruistic theory in Part III, before attempting to apply it to executive compensation in Part IV.

III. ALTRUISTIC THEORY

The free market solution to agency problems such as those posed by executive compensation is to institute mechanisms that better align agents' incentives with those of their principals, taking agents' preferences[186] as a given.[187] Popular devices such as options, performance bonuses, and restricted stock, as well as proposed reforms such as indexed options,[188] all fall into this incentives category.[189]

> extract rents. Thus, the hiring firm cannot attract them without compensating them for whatever rents they currently enjoy and must give up to take the new positions.

Bebchuk et al., *supra* note 48, at 842.

185. *Id.*

186. One of the fundamental assumptions of economics is that individuals are capable of transitively ordering their choices. For example, a person faced with a choice among mint chip, peanut butter, and cookie dough ice cream should be able to rank these choices in a transitive order. If Mary prefers mint chip to peanut butter, and peanut butter to cookie dough, she will necessarily prefer mint chip to cookie dough. These rankings are sometimes termed "preferences." *See generally* Sidney Schoeffler, *Note on Modern Welfare Economics*, 42 AM. ECON. REV. 880, 881 (1952); Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 322-323 (1977).

187. *See, e.g.*, Elson II, *supra* note 99, at 943 (explaining that the directors' interests must be aligned with those of shareholders through the grant of restricted stock); Gilson & Kraakman, *supra* note 48, at 883-92 (attempting to activate institutional investors, who as large shareholders should share most of the policy preferences of stockholders as a whole).

188. Indexed options adjust their exercise prices to some relevant market index in an attempt to adjust for general market movements that have little to do with the performance of the corporation itself.

189. *See supra* notes 22-23 and accompanying text.

The regulatory approach attempts to force individuals to act against their initial preferences by imposing large costs on behavior that is not considered socially desirable.[190]

An alternative approach is to employ the insights of behavioral law and economics to modify agents' preferences, making them want to choose socially desirable actions. Preference-shaping offers the possibility of sharply reduced agency costs. Agents who *want* to do what is best for their principals should not require large payments to induce them to act in their principals' interests. One promising source of preference modification is altruistic theory. This section explores altruistic theory with a view toward applying that theory to help resolve corporate governance problems generally, and the problem of executive compensation in particular.

A. *Definitions and Root Causes of Altruistic Behavior*

The American Heritage Dictionary of the English Language defines "altruism" as "[c]oncern for the welfare of others, as opposed to egoism; selflessness."[191] This definition accords with popular views of altruism. We tend to think of altruism as unselfish behavior, acts that involve bearing costs solely for another's benefit. Examples of such behavior range from giving gifts or making charitable donations to risking one's own life to save another's.

In contrast to the popular sense of altruism, most disciplines that study altruism empirically have ascribed selfish motives for acts normally considered altruistic. Sociobiologists have ascribed such behavior to "selfish genes," arguing that it may sometimes be in a gene's interest to produce altruistic-appearing behavior in the animals in which it resides.[192] Economists have similarly

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190. *See supra* notes 25-27 and accompanying text.

191. THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 39 (William Morris ed., 1969).

192. As Richard Dawkins has written:

> [A] predominant quality to be expected in a successful gene is ruthless selfishness. This gene selfishness with usually give rise to selfishness in individual behaviour [sic]. However, as we shall see, there are special circumstances in which a gene can achieve its own selfish goals best by fostering a limited form of altruism at the level of individual animals. 'Special' and 'limited' are important words in the last sentence. Much as we might wish to believe otherwise, universal love

argued that individuals behave from selfish motives, and that altruistic behavior must therefore stem from perceived individual advantages.[193] Psychologists have, along the same lines, mostly contended that altruists are motivated by a desire to terminate negative arousal stemming from perceptions of people in distress.[194] Some psychologists, however, have argued that true, empathy-motivated altruism does exist.[195]

Because all three of these disciplines largely ascribe selfish motives to altruistic acts, the popular, motivational, definition of altruism lacks usefulness. Defining altruism as an act motivated by empathy, or "[c]oncern for the welfare of others,"[196] describes a phenomenon that most experts believe does not exist. Instead, empirical researchers have often found it more useful to define altruism behaviorally, without regard to the underlying motivation. Richard Dawkins, perhaps the most prominent sociobiologist of the past few decades, has thus defined an altruistic entity as one that "behaves in such a way as to increase another such entity's welfare at the expense of its own."[197] Dawkins stresses that this definition ignores motivation altogether. As he has written:

> It is important to realize that the above definitions of altruism and selfishness are *behavioural*, not subjective. I am not concerned here with the psychology of motives. I am not going to argue about

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> and the welfare of the species as a whole are concepts that simply do not make evolutionary sense.

RICHARD DAWKINS, THE SELFISH GENE 2 (1989).

193. *See, e.g.*, Gary S. Becker, *Altruism, Egoism, and Geentic Fitness: Economics and Sociobiology*, 14 J. ECON. LIT. 817, 822 (1976) ("[A]n egoist has an incentive to try to simulate altruism whenever altruistic behavior increases his own consumption through its effect on the behavior of others."); William M. Landes & Richard A. Posner, *Altruism in Law and Economics*, 68 AM. ECON. REV. 417, 419 (1978) (explaining that altruists make wealth transfers to strangers to gain reward of favorable publicity); ERIC A. POSNER, LAW AND SOCIAL NORMS 49-67 (2000) (explaining the existence of gifts and gratuitous promises as devices used to signal possession of a low discount rate).

194. *See* BATSON, *supra* note 32, at 43-46 (explaining that most psychologists believe altruistic behavior is rooted in attempts to reduce negative arousal or some other egoistic explanation); Dovidio, *supra* note 32, at 410 (arguing that the literature generally supports the "economic man" approach).

195. *See* BATSON, *supra* note 32, at 109-174 (describing studies supporting the existence of empathy-driven altruism).

196. THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE, *supra* note 191, at 39.

197. DAWKINS, *supra* note 192, at 4.

> whether people who behave altruistically are 'really' doing it for secret or subconscious selfish motives. Maybe they are and maybe they aren't, and maybe we can never know, but in any case that is not what this book is about. My definition is concerned only with whether the *effect* of an act is to lower or raise the survival prospects of the presumed altruist and the survival prospects of the presumed beneficiary.[198]

I will adopt Dawkins' behavioral definition of altruism, though without the focus on genetic survival. For the purposes of this article, I will use the term "altruistic" to describe behavior that requires the "donor" to bear at least short-run costs in order to produce at least a short-run benefit to the "donee," where the costs and benefits involved are material rather than psychic.

I adopt the behavioral definition of altruism both to accord with theorists in other disciplines[199] and in order to provide for clarity in behavior labeling. We can directly observe actions and determine whether they appear to involve the actor's bearing short-run costs while assisting another. But, absent Judge Learned Hand's famous mind-reading bishops,[200] we cannot easily discern the actor's motivation or intent, or whether short-run costs are being borne in quest of long-term gains.[201]

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198. *Id.*

199. *See, e.g.,* Kanungo & Conger, *supra* note 32, at 242-43.

> Since it is often difficult to identify the helper's dispositional intentions, researchers have preferred to define altruism as a form of overt behavior that benefits others. In this sense, altruism as a behavioral construct has a broader scope which includes many forms of prosocial behavior (cooperation, helping, charity, empowering, and so on) that benefits others regardless of whether it is, in intent, unselfish or not.

Id.

200.

> A contract is an obligation attached by mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent. If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there was some mutual mistake, or something else of the sort.

Hotchkiss v. Nat'l City Bank of New York, 200 F. 287, 293 (S.D.N.Y. 1911).

201. *But see* BATSON, *supra* note 32, at 109-74 (attempting to prove through experimentation that some altruistic behavior is motivated by empathy).

B. *Factors Correlating with Altruistic Behavior*

The numerous empirical studies performed exploring altruistic behavior have identified a series of factors that correlate with altruism. Although correlation does not prove causation, the volume and variety of the studies may lend us some confidence that we may successfully induce altruistic behavior by taking advantage of some or all of these factors. Researchers have formulated a number of different theories for why people sometimes behave altruistically, and we are very far from anything even approaching a consensus on this causation question. Although a better understanding of altruism's root causes would certainly be very helpful, the current indeterminacy of the answer does not close off altruism's usefulness to social science in general or to law in particular.

We can divide the correlative factors into three groups: perceptive, internal, and external. Perceptive factors involve individuals' discernment of their environment. Thus, people are more likely to behave altruistically when their perception of the need is particularly clear,[202] when they believe they are capable of rendering assistance,[203] and when they are similar to or have some relationship with the person in need leading to empathy.[204] Enhancing such perception may increase the odds of altruistic behavior.[205]

Internal factors consist of the emotions, moods, or traits of the potential altruists. They include the salience of social norms advocating helping behavior ("helping norms"),[206] a sense of responsibility for the person in need,[207] feelings of happiness or high self-esteem,[208] and the possession of certain personality traits.[209] Manipulating the actor's

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202. *See supra* note 33.
203. *See supra* note 34.
204. *See supra* note 35.
205. *See supra* notes 33-35.
206. *See supra* note 36.
207. *See supra* note 37.
208. *See supra* note 38.
209. *See* BATSON, *supra* note 32, at 177-201; Carlo et al., *supra* note 32, at 456-57 (citing a study that demonstrates how both personality traits and environmental factors are important in predicting altruistic behavior); KOHN, *supra* note 32, at 76-82 (discussing personality traits that influence altruistic behavior such as self-esteem, assertiveness, interpersonal skills, and political beliefs); Korsgaard et al., *supra* note 32, at 161-62 (attaching less importance to personal consequnces of social information and exhibiting greater reluctance to

environment to foster or select for these internal factors may increase the incidence of altruistic behavior.[210]

External factors affect the likelihood of altruistic behavior through situational characteristics. These include the expected utility of helping versus ignoring the person in need,[211] the relative ease of escape (either physically or through coping mechanisms),[212] and the extent to which external forces perceptibly attempt to coerce helping behavior.[213] Contextual changes may be arranged that strengthen altruism's likelihood.

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engage in rational calculations); J. Philippe Rushton, *The Altruistic Personality: Evidence from Laboratory, Naturalistic, and Self-Report Perspectives, in* DEVELOPMENT AND MAINTENANCE OF PROSOCIAL BEHAVIOR 271-87 (Ervin Staub et al. eds., 1984) (marshalling evidence supporting the existence of a trait of altruism); Staub, *supra* note 32, at 138-39 (discussing how prosocial orientation—a positive view of human beings, concern about other people's welfare, and a feeling of personal responsibility for others' welfare—correlates with altruism). *But see* Schwartz, *supra* note 32, at 272-73 (claiming that the evidence argues against the existence of an altruistic personality).

210. *See supra* notes 36-38, 207.

211. *See* BATSON, *supra* note 32, at 88-89; Batson & Coke, *supra* note 32, at 176-77 (arguing that costs reduce the likelihood of altruism); Becker, *supra* note 193, at 822 (demonstrating how altruism is rooted in an attempt to secure gains); Dovidio, *supra* note 32, at 410 ("[P]eople tend to behave as if to minimize costs and maximize rewards."); EISENBERG, *supra* note 32, at 198-99 (explaining that expected utility is a factor in deciding whether to behave altruistically); POSNER, *supra* note 193, at 49-67 (giving gifts is a part of a cost-maximizing attempt to signal possession of a low discount rate); Schwartz, *supra* note 32, at 241 (assessing costs is the first step in defending against demands of the needy); Schwartz & Howard, *supra* note 32, at 235 ("People do not help when the cost-benefit analysis clearly opposes the possible helping actions."); Norman Frohlich et al., *Beyond Economic Man: Altruism, Egalitarianism, and Difference Maximizing*, 28 J. CONFLICT RESOLUTION 3, 15 (1984) ("[T]he costs involved . . . affect preferences for the realization of moral goals much as prices affect the demand for consumer goods."); Korsgaard et al., *supra* note 32, at 161-62 (explaining that people who are less likely to calculate costs are more likely to engage in altruistic behavior); and Landes & Posner, *supra* note 193, at 419 (explaining that altruism stems from an attempt to obtain a reward of favorable publicity).

212. *See* BATSON, *supra* note 32, at 104-05, 110, 112-27; Dovidio, *supra* note 32, at 399-400 (demonstrating the diffusion of responsibility as a method of escape); Schwartz, *supra* note 32, at 264 (explaining that excessive pressure may provoke escape through, *inter alia*, denial of need); and Schwartz & Howard, *supra* note 32, at 203-07 (explaining escape through coping mechanisms such as denial of need, denial of effective action, denial of personal ability, and denial of responsibility).

213. *See* Schwartz & Howard, *supra* note 32, at 207-08 (explaining the "boomerang effect").

1. *Perceptive Factors*. Most theorists agree that a clear perception of need is a necessary or at least usual prerequisite of altruistic behavior.[214] C. Daniel Batson, one of the leading altruism theorists, has pointed out that perception of need is "a threshold function of (a) a perceptible discrepancy between the other's current and potential states on some dimension(s) of well-being, (b) sufficient salience of these states, and (c) the perceiver's attention being focused on the other."[215] In other words, helping behavior correlates with the degree to which another's situations could be greatly improved, the conspicuousness of this potential change, and the extent to which the actor notices this discrepancy between the other's actual and potential states of well-being. The potential altruist will not think to offer assistance if he or she fails to perceive the would-be donee's need, so need perception is a gate-keeping factor.[216] Helping behavior should increase with the clarity of the need for assistance and the putative donor's receptivity to need cues.[217] Once need awareness passes some initial threshold, the likelihood of helping behavior increases with the intensity and clarity of the need for help.[218]

Thus, one study demonstrated that people were more likely to donate an organ after hearing a detailed description of the problems of those requiring bone-marrow transplants.[219] The description of the need amplified the need's clarity making altruistic behavior more likely.

In addition, many scholars have argued that potential altruists will be more likely to render assistance when they believe they are capable of helping effectively.[220] Belief in at least three different types of competence is important to

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214. *See* sources cited *supra* note 33.

215. BATSON, *supra* note 32, at 83.

216. *See* Schwartz, *supra* note 32, at 241 (describing need perception as an "activation step").

217. *See* Schwartz, *supra* note 32, at 242 ("The variables which influence initial awareness of need are the prominence of the need in the environment, its clarity, and individual receptivity to need cues."); Schwartz & Howard, *supra* note 32, at 232-33 ("Situational salience and clarity of need as well as individual receptivity to need cues increase awareness of need.").

218. *See* Schwartz, *supra* note 32, at 243 (intensity); and KOHN, *supra* note 32, at 71 (clarity).

219. *See* EISENBERG, *supra* note 32, at 194.

220. *See* sources cited *supra* note 34.

induce helping behavior.[221] The potential altruist must possess "a general belief in one's ability to influence events and successfully pursue goals; the capacity to generate plans of action or the knowledge of action on specific occasions; and specific competence to act in required ways (such as the ability to swim in order to save a drowning person)."[222] Social competence may also be important.[223] Socially inhibited individuals may refrain from helping out of fear of embarrassment.[224]

Intuitively, the link between ability to help and tendency to help seems obvious. The tangible and psychic rewards associated with rendering assistance are at least partly linked to success in alleviating the donee's distress. In addition, when competence stems from experience, familiarity with the situation and knowledge of the appropriate response may also encourage helping behavior. Thus, we would expect higher percentages of doctors to offer the victim treatment in accidents, of police officers to assist in stopping crimes even when off-duty, and of off-duty or retired fire fighters to race into burning buildings in search of victims.

In one study supporting a relationship between competence and altruism, subjects were told that their responses could help a victim of electric shock.[225] While generally the speed of response varied with the degree of the victim's suffering, subjects who were told their responses could not help did not respond more quickly as the victim's suffering increased.[226] Instead, these subjects invested more time in attempting to distract themselves from perceiving the victim's anguish.[227]

Although studies have been performed on this factor,[228] there is not a great deal of supporting empirical data,[229]

221. *See* Staub, *supra* note 32, at 144.

222. *Id.*

223. *See* EISENBERG, *supra* note 32, at 207.

224. *See id.*

225. *See* Schwartz, *supra* note 32, at 246.

226. *See id.*

227. *See id.*

228. *See* Shalom H. Schwartz, *The Justice of Need and the Activation of Humanitarian Norms*, 31 J. SOC. ISSUES 111, 119-20 (1975) (citing several studies supporting role of competence in activation of humanitarian norms).

229. *See id.* at 119 (describing research evidence for the impact of actual ability on responsiveness as "sparse"); Schwartz, *supra* note 32, at 245

perhaps because this relationship seems so clear.[230] Until more studies can be done measuring the importance of this factor, we should incorporate it into models only with great caution.

A third perceptive factor often linked to altruism is some similarity or relationship between the potential altruist and the person in need.[231] This factor operates through its effect on empathy, an emotional response appropriate to someone else's situation rather than to one's own.[232] Empathy is widely believed to play an important role in inducing altruism, either selflessly, through an internalization of others' needs, or egoistically, through an aversive reaction to negative arousal.[233]

People are more likely to feel empathy for a person who is similar to them or with whom they have some relationship.[234] The greater the perceived similarity and the closer the relationship, the stronger the empathic response experienced by the potential altruist.[235] Batson has argued that similarity enhances empathy by boosting one's ability to take the perspective of another.[236] Empathy, Batson contends, is a function of both a natural ability to put oneself in another's shoes and the "perspective-taking set," knowledge gleaned from various sources that allows a person to imagine how someone else is feeling.[237] The perspective-taking set can be expanded by experience, instruction, or a feeling of attachment to the other.[238] Feelings of attachment in turn come from either direct contact or from generalizations based on contact with

(describing research evidence supporting link between perceived ability to help and helping behavior as "meager").

230. *But see* EISENBERG, *supra* note 32, at 196 (arguing that a perceived ability to help may not be a prerequisite to assistance in emergencies, because people may help before thinking through the situation).

231. *See* sources cited *supra* note 35.

232. *See* BATSON, *supra* note 32, at 51, 56, 113-17, 177; *see also* Rushton, *supra* note 209, at 271 (defining empathy as "experiencing the emotional state of another.").

233. *See* BATSON, *supra* note 32, at 47-51, 54-58, 83-90.

234. *See id.*; Staub, *supra* note 32, at 142 ("[P]eople respond more empathically to similar others, even if the similarity is limited in nature.").

235. *See* sources cited *supra* note 232.

236. *See* BATSON, *supra* note 32, at 84.

237. *See id.*

238. *See id.*

similar people.[239] Attachments grounded in generalizations are generally weaker than those based on personal contact.[240]

Some experimental support for the notion that altruism is more likely to the extent there is a similarity or relationship between the potential donor and donee comes from a study by Harvey A. Hornstein.[241] Hornstein dropped unsealed envelopes around Manhattan that contained a wallet and a letter. The letter indicated that the author had discovered the wallet and planned to mail it back to the owner. The clear implication was that the letter's author had dropped the package while on the way to the post office. Some letters described the author as similar to most of the package finders, while others described the author as rather different. In addition, in some letters the author expressed annoyance at the trouble involved in returning the lost wallet, but in others the author appeared pleased about the opportunity to do a good deed. Package finders who read the "similar" letter were much more likely to take on the emotion expressed than those who read the letter describing the author as someone relatively alien to the finder.[242] Thus for "similar" letters, if the letter expressed positive feelings, the finder was much more likely to mail the package than if the letter expressed negative feelings.[243] In contrast, the emotions described by dissimilar authors had no impact on the incidence of helpful behavior.[244] This result indicates that people are more likely to identify with those perceived to be similar to them.

2. *Internal Factors*. There are four internal factors that affect altruism. The first is the salience of helping norms.[245] People tend to behave more altruistically when the social rules requiring prosocial behavior are especially apparent. Salience may contribute to altruistic behavior by clarifying

239. *See id.* at 85.

240. *See id.*

241. *See* Hornstein, *supra* note 32, at 31-36; *see also* Berkowitz, *supra* note 32, at 87 (discussing Hornstein's study).

242. *See* Hornstein, *supra* note 32, at 31-36; *see also* Berkowitz, *supra* note 32, at 87.

243. *See* Hornstein, *supra* note 32, at 35.

244. *See id.*

245. *See* sources cited *supra* note 36.

the benefits to be derived from helping others.[246] These rewards may include a likelihood of inducing reciprocal assistance at a later time from this donee or from others, an enhanced reputation for trustworthiness, social approbation, and emotional satisfaction, among others. Salience may also boost empathy by reminding potential altruists of the importance attached by the culture to other people and the consequent need to attempt perspective-taking.[247]

Leonard Berkowitz and Louise R. Daniels constructed a two-phase study to test whether boosting the salience of helping norms increased the incidence of altruistic behavior.[248] In the first phase, the subjects were assigned a preliminary task.[249] Half the subjects were assisted by a peer who was actually the experimenters' confederate, while the other subjects received no help.[250] Afterwards, the subjects were assigned a second task, supervised by a different supposed peer.[251] The experimenters told half the subjects the supervisor's reward depended on the subject's performance (the "dependent group"), and the other half that there was no relationship between the subject's performance and the supervisor's reward (the "independent group").[252] Among the dependent group, subjects who had received assistance in the first phase tended to try harder to perform the second task,[253] presumably because receiving assistance in the first phase had reminded them of the social norm that requires some degree of altruistic behavior.[254]

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246. *See* Hornstein, *supra* note 32, at 30.

247. *See generally id.* at 30-31 (discussing the efffect of a model that demonstrates how people are expected to behave).

248. *See* Leonard Berkowitz & Louise R. Daniels, *Affecting the Salience of the Social Responsibility Norm: Effects of Past Help on the Response to Dependency Relationships*, 68 J. ABNORMAL & SOC. PSYCH. 275, 276-77 (1964).

249. *See id.* at 276.

250. *See id.*

251. *See id.* at 276-77.

252. *See id.* at 277.

253. *See id.* at 280.

254. *See id.* at 280-81. Another study demonstrating the importance of the salience of helping norms involved inducing children to share winnings from a game with poor children. Some of these children were told they had helped because they were the kind of people who help others (an "internal attribution"), while others were told they had helped because the experimenter wanted them to (an "external attribution"). Those children who were given an internal attribution were more likely to help later than those given an external attribution. A likely explanation for this difference is that helping norms were

The second internal factor is the donor's sense of responsibility for the person in need.[255] A sense of responsibility may stem from having caused the distress in question, being placed in a position of authority or accountability, possessing a unique ability to assist due to specialized skills or physical position, being asked for help, or from the victim's dependency.[256] Responsibility or dependency relationships may lead to a deeper emotional attachment, fostering empathy.[257] Skills or position-based responsibility may also lead to altruistic behavior by lowering the costs of helping, or by increasing the social sanction of standing idle.[258] Responsibility rooted in direct appeals may foster altruism by clarifying the need and highlighting social helping norms.[259]

The Berkowitz-Daniels study described above also demonstrated the efficacy of feelings of responsibility in inducing altruistic behavior.[260] The second phase task involved constructing paper boxes.[261] In this second phase of the study, half the subjects were told that their supervisor's reward depended on their efforts (the "High Dependency" condition).[262] The other half were told that because individual box-construction ability varied so greatly, the experimenters would evaluate the supervisors only on the clarity of the supervisors' orders and not on the number of boxes completed (the "Low Dependency" condition).[263] The study found that High Dependency subjects tended to produce significantly more boxes—controlling for ability—

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more salient to those children given the internal attribution. *See* Dovidio, *supra* note 32, at 382-83.

255. *See* sources cited *supra* note 37.

256. *See* Schwartz, *supra* note 32, at 246-50.

257. *See* BATSON, *supra* note 32, at 85; Schwartz, *supra* note 32, at 246 ("Responsibility refers to a sense of connection or relatedness with the person in need.").

258. *See* Schwartz, *supra* note 32, at 248.

259. *Id.* at 249 ("In addition to inducing responsibility, of course, appeals may promote helping by drawing attention to the existence of a need, overcoming ambiguity regarding its reality, and pointing to social expectations for behavior.").

260. *See* Berkowitz & Daniels, *supra* note 248, at 280-81.

261. *See id.* at 276.

262. *Id.* at 277.

263. *Id.*

than Low Dependency subjects,[264] indicating that feelings of responsibility tend to increase the incidence of altruism.

The third internal factor is the happiness or self-esteem of the potential altruist.[265] Joy and confidence may encourage altruism by reducing self-absorption, opening the potential altruist to the feelings and needs of others.[266] Too much self-esteem, however, may interfere with self-examination, preventing the actor from noticing flaws in his or her behavior that require correction.[267] This factor does not appear easy to manipulate in the corporate context.[268]

The fourth and final internal factor associated with altruism is the possession of certain personality traits.[269] Researchers point to traits such as sympathy or empathy,

264. *See id.* at 278.

265. *See* sources cited *supra* note 38.

266. *See* Dovidio, *supra* note 32, at 398 (explaining that good moods direct attention towards others, facilitating helping); Staub, *supra* note 32, at 145 ("Positive experiences can free people of self-concern, which is often present to some degree in social relationships.").

267. *See* EISENBERG, *supra* note 32, at 202-03 (discussing Staub's view); Staub, *supra* note 32, at 145 (explaining that children with a very high self-concept may feel self-sufficient and be less concerned with their connections with others).

268. Interestingly, sadness may also increase altruistic behavior under some circumstances. *See* Berkowitz, *supra* note 32, at 83-86; Dovidio, *supra* note 32, at 391-98; KOHN, *supra* note 32, at 73-75; Staub, *supra* note 32, at 144-46. Melancholy may encourage altruistic behavior because an unhappy person has a stronger motivation to find a method of elevating his or her mood. *See* Dovidio, *supra* note 32, at 389 ("[R]esearchers have suggested that people who experience negative states help because it is perceived as a way of reducing unpleasant arousal."). The emotional rewards of altruism may appear a desirable remedy for the heavyhearted. *See id; see also* Berkowitz, *supra* note 32, at 83 (feeling guilt may motivate helpfulness, even if beneficiary is not the source of the guilt). Sadness seems especially likely to motivate helping behavior when the low mood has been caused by focus on the misfortunes of others. *See* KOHN, *supra* note 32, at 73 ("[P]eople who feel sympathetic sadness or guilt are often among the most likely to help."). In such cases, altruism may prove a particularly potent cure. Note, however, that if the motivation consists of a search for a general mood elevator, the beneficiary of the donor's altruistic act may not be the same person whose misfortune caused the donor's melancholy. *See* Berkowitz, *supra* note 32, at 83 ("[F]indings suggest the victim of the injustice is not necessarily the preferred beneficiary for the expiatory assistance."). Also, if sadness leads to too much self-reflection, the actor may be too focused on his or her own troubles to perceive the needs of others, reducing the likelihood of altruism. *See* KOHN, *supra* note 32, at 73 (feeling bad reduces prosocial behavior because the subjects are preoccupied with their own state of mind).

269. *See* sources cited *supra* note 209.

feelings of personal responsibility for people's well-being, a positive orientation toward others, and docility as predictive of altruism.[270] Few, if any, scholars claim that an altruistic personality will always produce altruistic behavior. Instead, these characteristics interact with attributes of the environment.[271] As noted researcher Alfie Kohn has explained:

> [T]wo people in the same situation may have different motives for helping, and one person may have different motives for helping in each of two situations. Even if an altruistic personality or prosocial orientation exists, this hardly means that someone so characterized will rush to aid other people without taking environmental factors into account. If nothing else, such basic situational variables as whether helping is likely to bring rewards (or reciprocity) will mediate the effects of dispositional helpfulness. (The promise of a reward makes some people more likely to help and others less likely; one needs to know something about the person *and* the situation to make a prediction.) It has long been part of the conventional wisdom in personality theory that the salience of the cues provided by the environment largely determines which of these two will be more useful in predicting behavior: where the situational factors seem less clear cut, dispositional factors will become more relevant.[272]

Some personality traits popularly believed to correlate with, or cause, altruistic behavior surprisingly do not. For example, religious belief does not strongly correlate with

270. *See* Rushton, *supra* note 209, at 278-79 (pointing to empathy, perspective-taking, internalized rules of justice, social responsibility, honesty, self-control, feelings of personal efficacy and well-being, integrity); Staub, *supra* note 32, at 147 (pointing to moral value orientations, empathic potential, self-concept, self-esteem, self-awareness, self-acceptance, competence, and role taking); Carlo et al., *supra* note 32, at 450 (pointing to sympathy, social responsibility, ascription of responsibility, and perspective taking); Korsgaard, et al., *supra* note 32, at 161-62 (attaching less importance to personal consequences of social information, reluctance to engage in rational calculations regarding social information); Herbert A. Simon, *Altruism and Economics*, 83 AM. ECON. REV. 156, 157 (1993) (pointing to docility).

271. *See* KOHN, *supra* note 32, at 84; RUSHTON, *supra* note 32, at 55 ("[B]ehavior is the result of an *interaction* between personality and situational factors."); Carlo et al., *supra* note 32, at 450 ("[T]hose who support the notion of an altruistic personality have suggested that there is a person-situation interaction in regard to altruistic tendencies.").

272. KOHN, *supra* note 32, at 84.

altruism.[273] Gender also does not appear to correspond with altruism in any significant way.[274] There is evidence that individuals adhering to progressive political beliefs, however, do tend to exhibit more altruistic behavior.[275]

In one study demonstrating the interaction between personality and the environment, the subject observed a woman reading journalism students' descriptions of an assault.[276] The woman, the experimenters' confederate, apparently became upset, explaining that the stories reminded her of an assault she herself had suffered.[277] The researchers then asked the subjects whether they would take the woman's place.[278] Subjects who agreed would need to reschedule for a different time and place, without any additional compensation in the form of class credit.[279] Agreeing to take the confederate's place therefore involved a substantial sacrifice of the subject's time. Subjects' willingness to substitute for the confederate and bear this added inconvenience correlated well with measured indexes of altruistic personality traits, indicating that possession of these traits was predictive of altruistic behavior.[280]

3. *External Factors*. There are three external factors linked to altruistic behavior. The first external factor that affects altruism—and arguably the most intuitive—is the expected utility of helping.[281] For economists, of course, cost-benefit calculations lie at the root of all decisions, including those labeled altruistic.[282] It is not surprising, therefore, that economists generally hold that helping behavior is

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273. *Id.* at 79-80 ("[R]eligious faith appears to be neither necessary for one to act prosocially nor sufficient to ensure such behavior; in fact, there is virtually no connection one way or the other between religious affiliation or belief and prosocial activities.").

274. *Id.* at 81-82 ("Those who believe that gender differences are the exception in most sorts of helping behavior, and that the differences that do turn up are generally slight, seem to have most of the evidence on their side.").

275. *Id.* at 80 ("[I]t would seem that beliefs or activism of the sort sometimes called progressive are generally (though, of course, not exclusively) associated with prosocial behavior.").

276. *See* Carlo et al., *supra* note 32, at 452.

277. *See id.*

278. *See id.*

279. *See id.*

280. *See id.* at 453.

281. *See* sources cited *supra* note 211.

282. *See* sources cited *supra* note 193.

more likely when the expected costs are low relative to the expected benefits.[283] They have explained the apparent contradiction of rational utility-maximizers knowingly bearing costs for another's benefit by searching for hidden benefits that might compensate actors who lend assistance.[284] Sociobiologists argue along the same lines, though they tend to define cost and benefit in terms of genetic survival rather than individual utility.[285] Somewhat more surprisingly, psychologists also highlight the importance of expected cost to decisions about potential altruistic acts.[286] For psychologists, as well as some economists, costs and benefits consist not only of the material, but also the emotional.[287] Potential helpers must

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283. *See* Becker, *supra* note 193, at 819 (explaining that an altruist will act to maximize own (real) social income); Landes & Posner, *supra* note 193, at 418 (explaining that altruistic rescue may occur when cost of rescue is very low); *cf.* POSNER, *supra* note 193, at 50-51 (explaining that expensive gifts constitute more effective signals of low discount rates, but donor will spend minimum amount necessary to distinguish his type).

284. *See* POSNER, *supra* note 193, at 51 (signaling altruist's low discount rate); Becker, *supra* note 193, at 821 (linking consumption and inducing cooperation through altruism); Landes & Posner, *supra* note 193, at 419 (desiring favorable publicity); Simon, *supra* note 270, at 156-57 (increasing fitness through docility because of bounded rationality).

285. *See* DAWKINS, *supra* note 192, at 4; Becker, *supra* note 193, at 817-18 (discussing the work of E.O. Wilson); Landes & Posner, *supra* note 193, at 418-19 (citing other biologists who argue that altruism may increase the likelihood of the altruist's genes surviving).

286. *See* BATSON, *supra* note 32, at 78-82, 88-89; EISENBERG, *supra* note 32, at 198-99 (explaining that expected utility is a factor in deciding whether to behave altruistically); Batson & Coke, *supra* note 32, at 176-77 (noting that costs reduce the likelihood of altruism); Dovidio, *supra* note 32, at 410 ("[P]eople tend to behave as if to minimize costs and maximize rewards."); Schwartz, *supra* note 32, at 241 (assessing cost is the first step in defense against demands of needy); Schwartz & Howard, *supra* note 32, at 235 ("People do not help when the cost-benefit analysis clearly opposes the possible helping actions.").

287.

> Costs for helping may include feelings of aversion that are likely to arise when helping (e.g., if the victim is drunk or bloody, material losses, possible physical harm, or loss of social approval and potential social sanctions). These potential costs must be considered in light of potential gains such as social approval or recognition for helping and the avoidance of emotional costs (e.g., empathic arousal or personal distress) for not helping.

EISENBERG, *supra* note 32, at 199 (citation omitted); LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 21 (2002) (noting that welfare considerations include tastes for fairness);

weigh the guilt, shame and embarrassment of refusing to help against the contentment and self-esteem that result from giving assistance, as well as more material concerns.[288] When the sum total of these costs appears low compared to the potential benefits for some particular helpful act, the incidence of that act is predicted to be high.[289] Conversely, when the total expected costs appear to outweigh the expected benefits, relatively few acts of aid are expected.[290]

Research has borne out the important impact of cost-benefit analysis on decision-making. For example, Batson conducted a series of studies in which the subject watched the experimenter's confederate attempt various tasks.[291] The experimenter would appear to periodically administer an electric shock to the confederate.[292] After some time, the researcher would ask the subject to voluntarily replace the confederate, since the confederate appeared to be

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> The costs of helping (x) include the physical effort involved, the unpleasantness endured as a result of continued exposure to the other's distress, the unpleasant possibilities of becoming vulnerable to subsequent requests for help or enmeshed in long legal proceedings, and so forth. The costs of escaping (y) include the physical effort involved in escaping from the need situation (often minimal) and, more importantly, the feelings of guilt and shame one anticipates as a result of knowing that the person in need is continuing to suffer.

Batson & Coke, *supra* note 32, at 176;

> [P]ersonal costs for helping . . . involve negative outcomes directly imposed on the benefactor for making a direct helping response. Injury, effort, and embarrassment are examples of potential costs for helping. The other category is costs for the victim not receiving help. It contains two conceptually different subcategories. First, there are personal costs for not helping, which are direct negative outcomes for the bystander for failing to aid a victim. These include guilt and public censure. Second, there are empathic costs for the victim receiving no help, which are based primarily on the bystander's awareness of the victim's continued distress. In particular, these empathic costs involve internalizing the victim's need and distress as well as more sympathetic and concerned feelings for the victim.

Dovidio, *supra* note 32, at 383-84; Schwartz, *supra* note 32, at 253-54 (noting that the types of costs and benefits include social, physical, psychological, and moral); Schwartz & Howard, *supra* note 32, at 235 (noting that people identify the material, social, and psychological outcomes of helping behavior).

288. *See* EISENBERG, *supra* note 32, at 198-99; Batson & Coke, *supra* note 32, at 176.

289. *See* sources cited *supra* note 211.

290. *See id.*

291. *See* BATSON, *supra* note 32, at 113-19.

292. *See id.* at 113.

experiencing an unusually strong reaction to the shocks.[293] Batson manipulated the costs associated with refusing to assist the confederate by varying the number of tasks the subject would have to observe.[294] Subjects who would have to observe only a few tasks faced lower expected costs associated with a refusal to help, since they would not have to endure the confederate's apparent suffering for very long. As predicted, the incidence of helping behavior shrank when the costs of refusal were lowered, at least when empathy was not artificially heightened.[295]

Another study found that divinity students were less likely to stop to assist a groaning victim while on their way to deliver a sermon on the Good Samaritan if they were made to feel late (10% versus 63%).[296]

When the emotional costs of refusing assistance and the material costs of rendering assistance are both high, or when the cost-benefit calculation otherwise fails to yield a definite recommendation, some psychologists predict the use of one or more methods of escape.[297] These psychologists mostly embrace some form of egoistic altruism, motivated by a desire to reduce negative arousal rather than a pure devotion to the needs of others. Escape will not often satisfy the desires of someone motivated by pure empathy; a true concern for others will only be satisfied by actual

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293. *See id.* at 114-15.

294. *See id.* at 114.

295. *See id.* at 116.

296. *See* RUSHTON, *supra* note 32, at 55.

297. *See* Dovidio, *supra* note 32, at 384 (explaining that when costs of helping and not helping are both high and bystander therefore does not help, bystander is predicted to escape by derogating the victim, denying personal responsibility for intervention, or redefining the situation as one not requiring assistance);

> Conflict is experienced when anticipated moral costs for an action are high and opposed by nonmoral costs: Compliance with activated personal norms can satisfy feelings of moral obligation only at the risk of incurring substantial social, physical, and/or psychological costs. One way to escape this conflict is to neutralize the feelings of obligation, to deactivate the norms by redefining the situation. Three general modes of neutralization are inherent in the model presented here . . . [R]eassessment can lead to deactivation by denying the state of need (its reality, seriousness), by denying responsibility, or by viewing different actions or different implications of action as appropriate.

Schwartz, *supra* note 32, at 255.

assistance.[298] The relative ease of escape constitutes the second external factor affecting the likelihood of altruism.[299]

There are several methods of escape. The first and most obvious is physical.[300] People experiencing negative arousal from the sight of, for example, a homeless person shivering on a street corner, can simply walk past. Avoidance in this scenario is a much cheaper path to relief than assistance. The other methods are psychological. One can reinterpret the scenario as one not requiring intervention ("He likes being homeless");[301] create psychological distance by distinguishing between one's own situation and that of the person in need ("That could never happen to me");[302] refocus one's attention elsewhere ("I hate the news, let's turn on a sitcom");[303] ascribe the situation to the fault of the person in need ("This wouldn't have happened to her if she'd been willing to work as hard as we do");[304] remove oneself from responsibility ("The government provides social programs for people suffering this way");[305] tout the virtues of the well-off to explain their perquisites ("They earned every

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298. *See* BATSON, *supra* note 32, at 88-89.

299. *See* sources cited *supra* note 212.

300. *See* BATSON, *supra* note 32, at 79-80.

301. *See id.*; *see also* EISENBERG, supra note 32, at 197; Dovidio, *supra* note 32, at 384; Schwartz, *supra* note 32, at 256; Schwartz & Howard, *supra* note 32, at 236 ("A person may reexamine the situation, seeking cues that permit denial of the need or at least a reduction in its perceived severity (e.g., 'That's not an assault, it's a lovers' quarrel').").

302. *See* BATSON, *supra* note 32, at 80.

303. *See id.*

304. *See* RUSHTON, *supra* note 32, at 48 ("Persons witnessing harm done to others (e.g., when they see others living in slum conditions) might restore a sense of fairness by derogating the victim by convincing themselves that the victim deserved to suffer."); Berkowitz, *supra* note 32, at 104 ("People are much more willing to aid someone requiring assistance because of factors beyond his control than a person whose dependency is his own fault."); Dovidio, *supra* note 32, at 384 ("[D]erogate the victim . . . .").

305. *See* EISENBERG, supra note 32, at 197; Dovidio, *supra* note 32, at 384; Schwartz, *supra* note 32, at 256 ("Research on the phenomenon labeled 'diffusion of responsibility' postulates that situations are reassessed in order to deny or reduce responsibility to act, thereby neutralizing felt obligation.");

> [P]eople may deny their responsibility to conform with the moral or social obligations: They may claim that *under the circumstances* these personal or social norms do not reasonably apply. Denial of liability for action is justified by such extenuating circumstances as provocation, overwhelming outside pressure, job requirements, illness, and so on.

Schwartz & Howard, *supra* note 32, at 237.

penny they have");[306] and deny one's ability to help effectively ("Even if I gave this homeless person a dollar, it wouldn't do any good; he'd just use it to buy drugs").[307] Studies have demonstrated that personal norms ordaining altruism correlate with helping behavior only among people who tend to avoid the use of defense mechanisms.[308]

The third and final external factor affecting altruistic behavior is the extent to which external forces perceptibly attempt to coerce helping behavior.[309] Altruists naturally fear exploitation.[310] Their commitment to addressing the needs of others exposes them to vulnerability to opportunists.[311] For example, imagine an altruist who wants to support those who desire to work but cannot secure a job. People who do not work because they do not want to work may succeed in persuading such an altruist to give them money by falsely claiming the source of their joblessness is lack of opportunity, and not lack of desire or effort. Altruists' suspicion may therefore be easily aroused, particularly by claims that are overly forceful, dramatic, or overtly manipulative.[312] Such demands for assistance may

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306. *See* RUSHTON, *supra* note 32, at 48 ("Persons witnessing harm done to others . . . might restore a sense of fairness by . . . pointing to particular virtues present in those who are particularly well off, thus suggesting that they deserve their privileged positions.").

307. *See* EISENBERG, supra note 32, at 197 (denying competence to help); Schwartz, *supra* note 32, at 256 ("It is also possible to neutralize feelings of moral obligation by *increasing* the perceived seriousness of need and reinterpreting the situations as beyond hope."); Schwartz & Howard, *supra* note 32, at 236 ("People may conclude from reexamining the situation that the action in question would not be effective (e.g., 'No point intervening, they'll start up again as soon as I leave').").

308. *See* Schwartz & Howard, *supra* note 32, at 237-38 ("Four separate studies have found that personal norms correlate substantially with altruistic behavior among people who tend not to deny responsibility, but that the correlation is near zero among people high in responsibility denial.").

309. *See supra* note 213.

310. *See* Schwartz, *supra* note 32, at 264 ("The special danger of altruistic behavior is exploitation. In the absence of compensating social or material gains for self-sacrifice, and without the protection of reciprocity, equity, or law, the altruist may be drawn into an extensive sequence of demands.").

311. *Id.* ("Worse yet, altruists may discover that the needs to which they responded were not genuine, that they were created or portrayed to gain resources which the needy party could have sought through his own efforts.").

312.

> Trust in the purity of need may also be undermined by actions implying undue pressure or manipulativeness on the part of the person seeking help. Hence conditions conducive to generating feelings of

provoke what is sometimes termed a "boomerang effect," in which potential altruists respond with resentment at attempted impingements on their freedom of action rather than with assistance.[313] This reaction may in part be due to altruists' anticipating being deprived of the emotional rewards associated with helping others.[314] If altruists feel that they were forced to assist, they may not experience the boost in self-esteem associated with succoring others out of apparent goodwill.[315] The same dynamic may apply to offers to pay potential altruists for their cooperation.[316] One study confirming this effect demonstrated that college students were more likely to render assistance to someone in need if they believed they were free to refuse aid than if they thought they were compelled to help.[317]

> moral obligation will promote altruistic behavior only so long as they do not also induce suspicions that someone may be trying intentionally to manipulate one's perceptions of a situation in order to elicit emotions, images, value, or associations calculated to generate strong feelings of personal obligation.

Id.

313.

> If the critical threshold of pressure is traversed, feelings of moral obligation will be reduced and altruistic helping will decrease because: (1) the reality or seriousness of need may be denied; (2) the desire to retain one's behavioral freedom by resisting pressure . . . may be stimulated; and (3) external pressure may be experienced as replacing internalized motivation.

Id. (citation omitted),

314. *Id.* at 267-68 ("Dienstbier has suggested that [positive personal norms predispose people to feel manipulated because] those most likely to perceive their obligation and to respond after minimal pressure are denied the opportunity to feel good about their altruism if they perceive themselves virtually forced into the altruistic alternative.").

315. *Id.* at 264 ("When an appeal is overdone so that people perceive themselves coerced toward the altruistic alternative, they feel deprived of the self-satisfactions which are available when they act in response to their internalized moral obligations.").

316. *See* Schwartz & Howard, *supra* note 32, at 252 (citing a study demonstrating that housewives who agreed to a five-minute telephone interview without payment were more likely to agree to a longer interview than those who were paid to accede to the first request).

317. *See* Berkowitz, *supra* note 32, at 105.

IV. THE RANDOM SHAREHOLDER COMMITTEE: AN ALTRUISM-BASED PROPOSAL

Thus far, this article has argued that CEO compensation in U.S. public corporations is excessive and poorly structured, and that this problem stems largely from the separation of ownership and control and the capture of boards of directors by management. In addition, the article has explored altruistic theory, discussing environmental factors that have been demonstrated empirically to correlate with helping behavior. Now the article will make a first attempt at applying altruistic theory to the problem of CEO compensation. As explained in the introduction, this section is not intended to put forth a detailed plan of action, but rather to make some tentative suggestions based on altruistic theory's insights. The goal is to stimulate discussion in a new direction on a very old and important problem. While the proposal hopefully represents an important first step toward using altruism to shape preferences in ways that improve corporate governance, the true measure of this article's success will be whether it provokes others also to investigate reforms employing an altruism-based approach.

To apply altruism to the problem of executive compensation, we must create an environment that will help directors overcome their own self-interest. The problems with executive pay stem fundamentally from the absence of a well-functioning market. For a market to reflect efficient prices, there must be competition among self-interested purchasers attempting to secure goods and services at the lowest cost possible. No such competition exists in the realm of CEO pay because the purchasers of the CEO's services—the board of directors—are aligned in important ways with the CEO.

The board members' self-interest appears to lie not in seeking the best executive talent for the least money, but rather in pleasing the existing CEO in order to retain their own positions. Board members therefore can be expected to try to satisfy the CEO's compensation desires, rather than attempting to curtail those desires. Perhaps we can unleash the power of the market on executive compensation packages, resulting in far more efficient pay structures and levels, if we can induce directors to behave altruistically toward shareholders, putting shareholders' interests ahead of their own and negotiating more aggressively with CEOs.

The insights and studies discussed in the preceding section support the creation of a new entity for every U.S. public corporation, the Random Shareholders' Committee ("RSC"). RSCs would consist of small groups of small, long-term shareholders, people who own relatively small amounts of the company's stock and who have owned at least some portion of that stock for a substantial period (on the order of a year). They would be randomly selected and compensated for their time at a fairly generous daily rate.

The RSC's purpose is to induce altruistic behavior in the chair of the board's compensation committee by clarifying the chair's perception of shareholders' needs, enhancing his or her sense of identification with the stockholders, boosting his or her sense of responsibility toward the equity owners, and increasing both the costs of selfish behavior and the rewards of altruism.

To accomplish these goals, the RSC would meet with the chair of the compensation committee before the corporation begins salary negotiations with the CEO. At this meeting, the compensation committee chair would present the corporation's financial results in simple, straightforward terms. The chair would also explain the committee's initial proposal for the CEO's next compensation contract. The chair would remain and answer the RSC's questions regarding both the financial results and the compensation proposal until the RSC members were satisfied or until some maximum period for questions had elapsed.

After the compensation committee and the CEO have agreed on a compensation package, the chair would again meet with the RSC to present the package's terms in simple and clear language and answer the RSC's questions. A stenographer would transcribe the discussion in both sessions and publish the transcript on the corporation's web page. It might also be helpful to include some less structured social gathering time with the RSC and the chair of the compensation committee.

Before applying altruistic theory to explain the potential benefits of the RSC, we must recognize at the outset that the empirical data available, while voluminous, is not directly applicable. The studies performed thus far deal with contexts quite different from the corporate boardroom. Typically, these studies involve college students as subjects.[318] Also, these studies generally measure whether the subjects will bear relatively small costs, and involve situations where there may be strong social norms that call for helpfulness. This is a very different environment from the corporate boardroom, which generally consists of experienced, successful adults arguably acculturated to norms of self-interest. Just because manipulating some environmental factor may induce college students to build more boxes does not mean that same factor will induce board members to risk a prestigious and lucrative position. Nevertheless, while a great deal of empirical work on the boardroom context remains to be done, the existing studies should suffice as a starting place to begin research.

Based on the existing data, the RSC should help induce altruistic behavior in the chair of the compensation committee. First, spending several hours with small shareholders will permit the chair to learn first-hand about shareholder concerns. Members of the RSC will educate chairs, grounding them in the real-life problems and budgets of the middle class and implanting a more realistic sense of the importance of the money spent on executive compensation. Hearing about the financial struggles of the middle class and their needs may serve to remind the chairs of the enormous opportunity costs involved in richly compensating executives, and motivate them to attempt to curtail that compensation and to structure pay packages so that the corporation gains the maximum possible benefit for each dollar spent.[319]

Second, meeting shareholders will permit the chair to find common ground, enhancing a sense of identification with the stockholders and increasing the odds of altruistic behavior.[320] Unstructured social time may be particularly likely to create a sense of identification with shareholders.

Third, singling out a single player in the compensation process—the chair of the compensation committee—as accountable to the RSC for the results of the compensation negotiation should boost that individual's sense of responsibility toward the equity owners. Feelings of

318. *See, e.g., id.*; *see also* BATSON, *supra* note 32, at 52 and notes 225, 248.
319. *See supra* notes 214-19 and accompanying text.
320. *See supra* notes 231-44 and accompanying text.

responsibility are highly correlated with altruism.[321] More specifically, Rabindra Kanungo and Jay Conger have argued that business organizations can foster a sense of responsibility among their officers for their owners and others in part by assigning specific responsibilities for altruistic acts.[322] They believe that providing concrete, detailed instructions on who should be helped and how lends a sense of competence and certainty to altruistic behavior and also boosts feelings of self-esteem.[323]

Finally, publishing the transcript of the RSC's sessions will increase the cost of selfish behavior and the rewards of altruism. Publicizing shareholders' opinions that a CEO's compensation is too high or poorly structured should focus investors' attention on problems of corporate governance, perhaps putting pressure on the company's share price. In addition, greater publicity may exact a price in embarrassment from overly compliant boards. Conversely, publicity enhances the social and material rewards for selfless behavior, exhibiting good corporate governance to investors and perhaps garnering praise from the business press resulting in attendant reputation benefits for the board members. This last argument exhibits some of the overlap between altruistic theory and the free market approach. Both schools of thought recognize that cost-benefit analysis impacts individual behavior, though for altruistic theory net costs are merely one of many important variables.[324]

Several questions immediately arise about the structure of the RSC. First, why is membership on the committee limited to small, long-term shareholders? Second, why are these shareholders selected randomly and not elected? Third, why limit the RSC's meetings to the chair of the compensation committee instead of including the entire committee, the entire board of directors, or even the CEO? Fourth, will the RSC actually succeed in reducing and/or restructuring CEO compensation packages? Finally, if boards are captured by CEOs and CEOs are self-interested, how will a plan like the RSC ever be implemented?

321. *See supra* notes 255-64 and accompanying text.

322. Kanungo & Conger, *supra* note 32, at 253.

323. *Id.*

324. *See supra* notes 281-96 and accompanying text.

The first question was why membership on the RSC is limited to small, long-term shareholders. Requiring that members of the RSC have held some portion of their stock for a substantial period eliminates those investors—such as "day traders"—who have only a speculative interest in the company. Such short-term investors have little incentive to care about the company's long-term prospects and may therefore be more likely to accept RSC membership for the associated fees without working to achieve the RSC's goals. In fact, speculative investors may have perverse incentives. Speculators may profit by working against the corporation's interests, attempting to achieve a short-term decline in the corporation's stock price to purchase stock cheaply or to profit from a short position.

While limiting membership to long-term shareholders likely has implicit appeal, it seems counterintuitive to bar large institutional shareholders from the RSC. Numerous scholars have turned to institutional shareholders to solve the separation of ownership and control dilemma.[325] These commentators have argued that institutional shareholders—unlike typical small shareholders—have both the incentive and expertise to monitor corporate executives. By limiting RSC membership to small stockholders, the article appears to be guaranteeing that the RSC will lack the ability to check CEO avarice.

As explained above, however,[326] while institutional shareholders may possess the expertise for effective monitoring, they lack the requisite incentive. Because institutional investors diversify their equity investments, and because they increasingly employ indexing strategies, the large sums they invest are divided among a very large number of companies. As a result, the benefits from close

325. *See* Black, *supra* note 104, at 815-16 (advocating that the benefits to greater institutional investor monitoring outweigh dangers); Conard, *supra* note 104, at 176-78 (advocating reforms to facilitate institutional investor monitoring); Dent, *supra* note 104, at 882-83 (proposing to grant control of proxy solicitations to a committee of the corporation's largest shareholders); Gilson & Kraakman, *supra* note 48, at 880 (arguing for having institutional investors elect professional directors); Lipton, *supra* note 104, at 63-64 (proposing changes in the tax code to shift institutional investors' focus to the long-term); *cf.* Vanecko, *supra* note 104, at 378 (arguing that changes in the securities laws to facilitate institutional investor activism are not necessary or advisable, in part because institutional investors are already often successful in influencing management).

326. *See supra* notes 104-10 and accompanying text.

monitoring seldom exceed the costs. Still, one might argue that given a very low-cost monitoring mechanism such as the RSC, large shareholders might well participate. In addition, because such investors are much more sophisticated than typical small shareholders, they should be much more effective in their efforts to rein in executive salary excesses.

There are two problems with this line of argument. First, institutional shareholders already meet informally with management to express their concerns.[327] It seems unlikely that formalizing such contact—such as by allowing institutional investors to join or even dominate the RSC—would greatly enhance monitoring.

Second, far from being more effective monitors than small shareholders, private institutional investors are likely to be entirely ineffective in the compensation arena. As explained above,[328] there are several reasons why this is true. First, private institutional investors often have close ties to the corporations in which they invest and may seek business from the same companies whose stock they own. Rather than risk potentially lucrative new business, conflicted institutional investors may cheerfully permit executives to pay themselves exorbitant salaries, reasoning that the resulting new business easily offsets any loss suffered by the investor's equity stake.

Also, private institutional investors are themselves corporations, run by CEOs who desire large compensation packages. Deflating the market for executive compensation runs directly counter to these officers' interest because the more CEOs at comparable corporations receive in compensation, the easier it will be to justify increases in salary packages for the heads of institutional investors.

Finally, all institutional investors—even public pension funds—may be subject to status quo bias. Status quo bias refers to individuals' tendency to prefer the existing situation to any proposed change, when all else is equal.[329]

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327. *See* EISENBERG, *supra* note 89, at 122-23.

328. *See supra* notes 106-11 and accompanying text.

329. *See, e.g.*, Jennifer Arlen et al., *Endowment Effects Within Corporate Agency Relationships*, 31 J. LEGAL STUD. 1, 3 (2002) ("[A]n increasing body of empirical and experimental evidence demonstrates . . . [that] the maximum amount a nonowner would be willing to pay for an entitlement is often significantly less than the minimum amount she would demand to part with it if she initially owned it."); Jolls et al., *supra* note 27, at 27 (discussing the

For example, Daniel Kahneman, Jack L. Knetsch, and Richard H. Thaler demonstrated in a series of experiments that subjects given inexpensive objects such as mugs or chocolate bars instantly increased their valuation of those objects.[330] Institutional investors, accustomed to high CEO compensation packages, may have difficulty envisioning radical changes in either the magnitude or structure of those packages. While small shareholders are not often financially sophisticated, they can be expected to possess a strong sense of the importance of parsimony that board members, CEOs, and institutional investors, accustomed to dealing with seven to ten digit figures, may lack. Nevertheless, the risk of status quo bias may be outweighed by the benefits of greater sophistication for public pension funds, if not for private institutional investors. This question requires further study.

These arguments may explain why the RSC's members might be small, long-term shareholders, but that brings us to the second question: why must the members be randomly selected? The ideals of shareholder democracy would seem to be better served by electing the RSC's members. Elections might also protect the corporation at least to some degree from selecting RSC members who are incompetent or irresponsible.

The problem with elections is that they have proven largely ineffective as a counterweight to management's power. As explained above,[331] despite being elected by

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endowment effect); Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem, in* BEHAVIORAL LAW & ECONONOMICS, *supra* note 27, at 213-28 (reporting results of experiments supporting the endowment effect's existence);

> An unusually rich body of behavioral science literature demonstrates . . . that individuals often place a higher monetary value on items they own than on those that they do not own. Because the consequence of this effect is that people place a higher value on their endowments than on other items, this phenomenon is often referred to as the "endowment effect."

Russell Korobkin & Thomas Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1107-13 (2000); Russell Korobkin, *Behavioral Economics, Contract Formation, and Contract Law, in* BEHAVIORAL LAW & ECONOMICS, *supra* note 27, at 116 ("[T]he initital allocation of legal entitlements can affect preferences for those entitlements."). I am indebted to Russell Korobkin for the idea of applying the notion of status quo bias to this problem.

330. *See* Kahneman et al., *supra* note 329, at 225.

331. *See supra* Part II.

shareholders, directors have not advocated consistently for shareholder interests. Instead, boards of directors have generally deferred to management's decisions both in matters of general business strategy and in narrower questions of management self-interest, such as executive compensation.[332] Many of the causes of this deference stem from management's influence over the selection process.[333] Board member candidates are nominated by the existing board.[334] To the extent that management controls the existing board, it also determines who is nominated to fill board vacancies. As a result, critical board members are rarely nominated, and, when nominated and elected, are rarely nominated for a second term.[335]

The same problem would likely recur if RSC members were elected. If RSC candidates were selected by the board, then management's influence would likely permeate the process, giving shareholders no real choice but to elect compliant members. Institutional investors could be permitted to nominate candidates as well, but for the same reasons that institutional shareholders are themselves unlikely to oppose management interests in the compensation arena, they are unlikely to select proxies to do so.[336] Moreover, even if "opposition" candidates could somehow be nominated—perhaps by a coalition of public pension funds—shareholders would be unlikely to elect them. Shareholders have demonstrated a remarkably consistent history of voting for management proposals, even when they seem clearly against shareholder interests.[337] Management compensation plans almost always pass by

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332. *See id.*

333. *See supra* Part II(A).

334. *See supra* note 141 and accompanying text.

335. *See supra* note 144 and accompanying text.

336. *But see* Gilson & Kraakman, *supra* note 48, at 883-88 (arguing for professional directors hired by institutional shareholders).

337. *See* Barris, *supra* note 45, at 98 ("[O]f the more than one thousand resolutions advanced by corporate management . . . during the 1992 proxy season, only seven failed to pass."); Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia In Shareholder Voting Cases*, 79 IOWA L. REV. 485, 514 (1994) (noting that in 1993, out of 400 governance proposals at 225 companies, eleven received a majority vote); John Wasik, *Speak Loudly--Or Lose Your Big Stick*, FIN. TIMES, July 24, 2002 (USA ed2), at P26 ("Showing meager but growing success, only 13 shareholder proposals out of 712 resolutions filed in the past year by fund managers earned more than 20 per cent support from other corporate shareholders, the SAN reports.").

large margins, even when they seem excessive.[338] Random selection presents a promising method of purging pro-management influences from the selection process.

The third question of why the RSC should meet only with the chair of the compensation committee, and not the entire committee, is somewhat easier to answer. Studies indicate that a sense of responsibility for the person in need heightens the likelihood of altruistic behavior.[339] For example, a witness to an accident is more likely to assist the victim when there are no other bystanders than when many others also saw the accident.[340] Similarly, the chair of the compensation committee should feel more responsible for helping the shareholders—and should therefore be more likely to exhibit helping behavior—if the chair is the only director present at the RSC meeting than if the entire committee attends. Also, the RSC members, who will mostly be unfamiliar with corporate settings, may be somewhat intimidated at the prospect of facing an entire committee of board members. Outnumbering the committee chair by eight or more to one should hearten the RSC members considerably, encouraging more outspoken, assertive behavior.

If the RSC proves effective in inducing altruistic behavior, why not go straight to the source? In other words, why not have the CEO meet with the RSC? CEOs after all, already possess a great deal of power over their boards,

338. *See* Warren F. Grienenberger, *Institutional Investors And Corporate Governance*, *in* 2 PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 315, 322 (Klaus Eppler ed., 1996) (noting that no plans for director pensions have been defeated when put to a shareholder vote); E. Scott Reckard, *Vote Urges BofA Curb on Severance Compensation: Measure Seeking Limit for Execs is Passed by Shareholders with 51% Margin. Bank's Board Can Reject Request,* L.A. TIMES, Apr. 25, 2002 at C1 (noting that although Bank of America shareholders passed a resolution asking the board to limit severance pay for executives, the 13 similar severance measures tracked by the Investor Responsibility Research Center during the previous year received an average of only 32% of shareholder votes); Richard H. Wagner, *Obtaining Shareholder Approval of Stock Plans*, 11 INSIGHTS No. 12, at 15 (Dec. 1997) ("Without urging, record holders historically have not participated in the voting process in overwhelming numbers, but when they have, their support of management's stock plan proposals is extremely high, absent any high profile compensation or performance issues.").

339. *See supra* notes 255-64 and accompanying text.

340. *See* Berkowitz, *supra* note 32, at 73; Schwartz, *supra* note 32, at 256 (finding that diffusion of responsibility is partially a function of the number of other bystanders).

particularly in regard to their own compensation plans.[341] If we can engender altruism in CEOs the compensation problem may prove much more malleable. In addition, there may be indirect benefits to such altruism. CEOs feeling altruistic toward shareholders may also work harder and focus more on long-term appreciation of both share price and dividends, rather than focusing narrowly on short-term swings that will boost their own compensation under current pay structures.

Despite the potential advantages associated with more altruistic CEOs, the lower expected benefit of having CEOs meet with the RSCs seems to argue against involving them in the process. CEOs' interests are far more directly opposed to the RSCs' agenda than are directors'. For CEOs, what is at stake is their primary source of income. A small percentage decrease in salary or benefits may translate to a large absolute sum. Similarly, small changes in the compensation packages' structures may increase CEOs' risk substantially if the new rules better correlate pay to performance. In contrast, while directors may risk their board seats by asking the CEO for pay concessions, membership on a board of directors is a sideline, not a primary occupation. The costs attendant to a director's losing his or her board seat may therefore be significantly lower than for a CEO acceding to changes in his or her compensation package, and the likelihood of helping behavior commensurately higher. Nevertheless, involving CEOs may ultimately prove beneficial and should be explored further.

In addition to these structural critiques, there remains an additional crucial objection that the RSC must overcome. The fourth question to be addressed is whether the RSC will have any impact on executive salaries' magnitude or structure. In other words, will the RSC really work? This query can be broken down into two subsidiary questions. First, is altruism too weak a force to blunt the powerful self-interest inherent in directors' desire to safeguard their positions? Second, can shareholder members of the RSC act as effective advocates, or will they passively accede to the CEO's desires as transmitted by the compensation committee chair?

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341. *See supra* Part II(D).

The first point is effectively a restatement of the widespread skepticism raised whenever altruism is juxtaposed with questions of corporate governance. Although most of us will readily concede that altruism of some sort exists, many will argue that behavior that appears altruistic is really just a result of enlightened self-interest. For example, Eric Posner contends that gift giving is often motivated not by a desire for the well-being of the recipient but rather an attempt to signal to others that the giver has a low discount rate and can therefore be trusted as a contracting partner.[342] Even those who believe in selfless altruism may doubt its efficacy and durability. As even Batson, the leading proponent of the existence of empathy-driven altruism, has written, "[A]ltruistic motivation that blossoms from feeling empathy may be a fragile flower, easily crushed by overriding egoistic concerns."[343]

But recall that we do not require empathy-driven altruism for this proposal to work; egoistic altruism may function just as well for our purposes. Our concern is with the expressed behavior, not the motivation for that behavior. Numerous studies, some of which were discussed above,[344] indicate that factors such as clear perception of need, sense of responsibility, and personality traits enhance the odds of altruistic behavior. The RSC, which is designed to utilize these factors, may therefore enhance altruism.

In addition, executive compensation decisions involve very high stakes, sometimes amounting to hundreds of millions of dollars. The RSC should not prove very expensive to run. For example, if a dozen RSC members were paid $1000 per day, and the entire process required four days of their time, their total compensation would amount to $48,000. Even accounting for travel, food, lodging, and the value of the time of the chair of the compensation committee, it is difficult to imagine the RSC's cost exceeding $100,000.[345] Yet if the RSC succeeds in reducing average CEO pay by only 10%, the corporation will save an average of $1.1 million per year. This benefit is

342. *See* POSNER, *supra* note 193, at 49-62.

343. BATSON, *supra* note 32, at 125-26.

344. *See supra* Part III(B).

345. Personality testing should be even cheaper. Personality testing requires the services of a single psychologist for a few hours. Testing a dozen board members should not amount to more than a few thousand dollars.

magnified if CEO salary negotiations occur only every few years, since the benefits accrue each year but the corporation would only bear the RSC's cost during negotiation years.

Moreover, the RSC's benefits may go beyond the gross reduction in total compensation. The RSC's involvement in the process may also yield pay packages that are better structured to induce optimal CEO behavior. Also, altruistic sentiments initiated by the RSC may carry over into the board's functions more generally. Some researchers have argued that altruistic models enhance altruistic behavior in others.[346]

As for the second challenge, the demands on shareholder members of the RSC would be relatively minimal. Shareholders would not need to be confrontational. In fact, a hostile, aggressive RSC might undermine efforts to improve directors' feelings of identification with and affection for shareholders. RSC members' primary role would be to ask common sense questions and to familiarize the chair with their concerns and perspectives. Members would not be expected to possess the expertise of an accountant or lawyer; they would not need to understand the intricacies of corporate finance to be effective. The important points for the RSC would be the corporation's performance relative to its competitors and compared to its own past, the amount the CEO is to be compensated, and the relationship between CEO compensation and corporate performance. Most shareholders should be capable of understanding these points, at least on a surface level.

The final question concerns implementation. There are many ways a plan such as the RSC could be implemented, including voluntary adoption by individual boards, shareholder proposals, new rules by the stock exchanges, and mandatory state or federal regulations or statutes. It is premature at this stage to suggest any particular implementation method. The theoretical arguments described above in favor of the RSC require more direct empirical support before even voluntary adoption of the proposal can be firmly recommended. Mandatory regulation

346. *See* Kanungo & Conger, *supra* note 32, at 253 ("Individuals tend to behave altruistically when they perceive that others are behaving in an altruistic manner.").

should demand even greater evidence supporting the RSC's effectiveness. This article, therefore, has confined the discussion to evaluating the likelihood that the RSC will succeed based on the empirical data already available on altruism, delaying any detailed discussion of implementation until more direct studies indicate that implementation would be advisable.

CONCLUSION

Although there are these theoretical reasons to think these devices will be effective, there remains plenty of room for doubt. CEOs are known for being tough-minded and can be expected to be resistant to any manipulations. Why should they give up their pay just to please a handful of small shareholders? Since board members such as the compensation committee chair have historically proven to be captured by the CEO due to a number of factors, such as their incentive to maintain their board membership and the relatively low impact of CEO compensation on the bottom line, the chair may prove equally resistant to the RSC.

In addition, directors may honestly believe—and perhaps be able to persuade the RSC—that their duty to the shareholders demands that they not antagonize the CEO over an issue that may turn out to be of subsidiary importance to the company. Strengthening board members' altruism toward shareholders would not be expected to affect this dynamic.

These concerns are well-founded. But there are also many reasons to think the devices will be effective, at least some of the time. CEOs may cooperate with efforts to reduce or restructure their compensation somewhat in order to make themselves feel good. Cooperation seems particularly likely if any reduction is insufficient to affect their lifestyle materially, for example from $11 million to $10 million. Alternatively, CEOs may agree to a restructuring that better correlates pay with performance. Such concessions will also help CEOs appear benevolent and public-spirited, boosting their own and the company's image. A willing CEO would eliminate directors' incentives to resist attempts to lower or restructure CEO compensation, by cutting the tie between such efforts and risks of termination.[347]

These questions cannot be resolved through theoretical speculation or by reference to indirect studies. Clearly empirical research is called for. Ideally, such research would consist of direct experimentation, persuading a random sample of corporations to adopt the proposal and measuring any resultant change in compensation magnitude and structure. Since corporations appear unlikely to adopt these reforms at this early stage of research, however, a useful interim step would be to design studies that model corporate structures and examine the effect of these devices on subjects placed in positions analogous to those of corporate directors and CEOs. Hopefully this article will prompt others to take up this research and attempt to realize the enormous promise of altruistic theory for corporate governance.

347. Note, however, that the possibility of the CEO cooperating with this process also raises the specter of collusion between the CEO and the chair of the compensation committee. They could agree to inflate the initial compensation proposal in the chair's presentation to the RSC, planning to reduce the package to its original level (or replace its original structure) during the RSC process in order to appear altruistic. The success of such efforts to "game" the RSC process would depend on the failure of the RSC to induce the chair to behave altruistically. Obviously, such gaming can by no means be described as bearing any kind of a cost for the benefit of another. Whether chairs subject to the RSC process would consent to participate in efforts to manipulate it is an empirical question in need of investigation.